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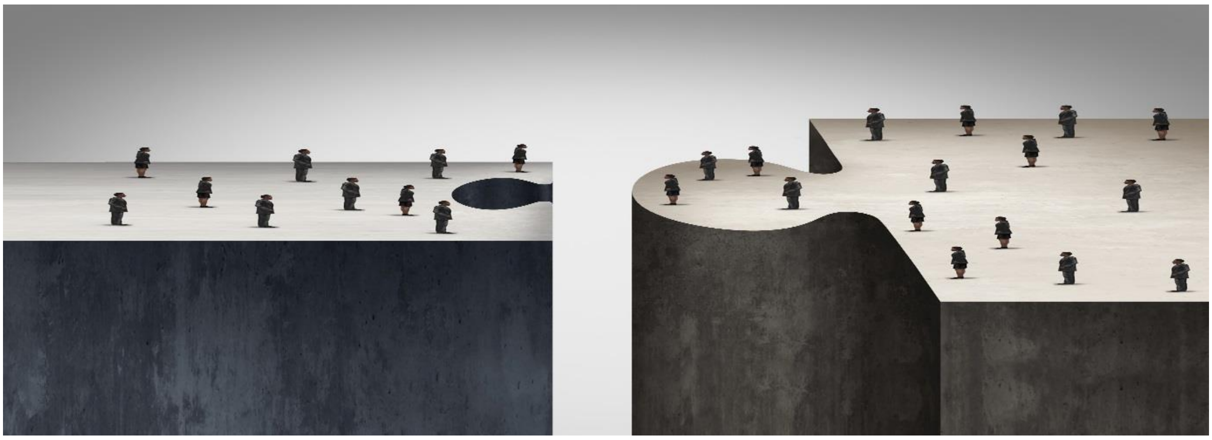
EBF POSITION ON IFRS 9 TRANSITION PERIOD (Proposed Article 473a of CRR2)



Background

As of 1 January 2018, European banks will have to substantially change the way they provision for credit losses. This follows from the implementation of a new accounting standard (IFRS 9) at EU level. Under IFRS 9, banks will be required to use forecasts of future economic conditions in calculating provisions and to estimate lifetime (stage2) provisions on significant portion of their loan books.

The interaction between the existing prudential framework and the forecasting elements of the new IFRS9 accounting standard creates a pro-cyclical mechanism that could present a serious systemic risk to the real economy. The prediction of a recession could become self-fulfilling, and the depth and length of that recession could increase, because banks are forced to increase provisions, and as a result may reduce lending, on the anticipation of a downturn, not when and if it actually occurs. Banks are expected to start with the consensus economic outlook and oversight from bank auditors will allow little deviation from that consensus. Given the nature of economic forecasting this could create significant volatility in bank lending to the real economy.

In addition, an increase in the level of provisions will have an adverse impact on banks' capital ratios, without a corresponding change in the level of risk, risk appetite, banks' strategy, management or level of losses.

The Basel Committee is undertaking a review of the interaction between the accounting and prudential regimes. It is however a complex topic with changes in both capital requirements as well as in accounting standards having occurred since the original Basel II implementation. The Committee has yet to reach its conclusions. The banking industry hopes that the review will address any potential overlaps to avoid capital being required for potential losses already covered by accounting provisions.

In its Resolution of 30 September 2016, the European Parliament recognised the impact of IFRS 9 on bank's capital and called for a progressive phase-in regime that would mitigate the impact of the new impairment model for a three-year period, or until an adequate international solution was put in place; and avoid any sudden unwarranted impact on banks' capital ratios and lending to the real economy.

Pending the Basel discussions, the European Commission has proposed a 5-year period to enable banks to mitigate the impact of IFRS 9 on regulatory capital based on a dynamic approach (CRR2 Article 473a).

What's the problem?

i) It is highly unlikely that the full CRR2 can be adopted and be in force as from 1 January 2018. To provide the intended relief, **any transition regime must be implemented from 2018** i.e. the effective date for the implementation of IFRS.

ii) The European Commission's proposal includes in the scope of the transitional arrangements, provisions that would have been recognised as IBNR (Incurred but not reported) under IAS 39 and, although likely unintended, the proposed transitional arrangements could also be interpreted as including provisions for already impaired assets (stage 3). The Commission's proposal also provides for possible overcompensation as provisions that would be added back under the Article 473a could also benefit from the treatment in the current prudential framework, being used to reduce the risk exposure amount or increase Tier 2 capital. **The proposal should be modified to ensure that only provisions arising from IFRS 9 are subject to the transitional approach**.

iii) We agree with an urgent need for a transitional period. Nevertheless, we believe that **the proposed amortization calendar should be slightly modified**.

What should the solution be?

i) **It is necessary to 'fast-track' changes in Article 473a. There is a need for clarity on the final transitional approach as soon as possible.** It is important that the European Parliament and the European Council accelerate the discussions to ensure that transitional arrangements are in place sufficiently before the 1 January 2018 when IFRS 9 enters into effect to enable entities to prepare their systems, strategic and capital plans and communication with the relevant stakeholders (supervisors, regulators, investors, etc.). Without such clarity, banks will have to consider what commercial actions and reduction in lending to certain sectors of economy will have to take place now to ensure that they are in a position to pass stress testing in 2018 under the new IFRS 9 accounting framework.

ii) We believe it is **important to maintain a dynamic approach** as proposed by the European Commission. We believe the dynamic approach to be **conceptually superior** to a static approach as it would allow for a more realistic quantification of the impact of IFRS 9 during the transitional period, considering any changes to the size and composition of portfolios or to forecasts of forward looking information. A static approach would only be appropriate if there was certainty of no significant evolution in the size and composition of portfolios or to forecasts of forward looking information during the transitional period.
To ensure that only provisions arising from IFRS 9 are subject to transitional approach, we suggest that the difference between the lifetime expected credit loss provisions of stage 2 financial instruments and 12 months expected credit loss provisions of stage 2 financial instruments at each reporting date is added back in full to CET1 for a minimum period of 2 years under both the IRB and standardised approaches, followed by a phasing period.

While it cannot be assumed that IBNR under IAS 39 would be equal to 12 months expected credit losses under IFRS 9 (IBNR will likely be smaller), it is expected that, in most cases, the main impact of IFRS 9 will stem from the requirement to provision for lifetime expected losses in stage 2 and thus more realistically approximates the IFRS 9 impact without any need to restate financial statements under IAS 39. This approach will require calculation of 12 months expected credit losses for all stage 2 assets, above the requirements of IFRS 9, for prudential purposes only.

For banks applying the IRB approach, provisions that would fall within the "shortfall" of accounting provisions at the given reporting date in comparison to regulatory expected losses would be disregarded from the transitional approach.

For standardised portfolios, only provisions associated to the 12 months expected losses would be deducted from the exposure as specific credit risk adjustments, or considered as Tier 2 if they are classified as general credit risk adjustments (if this category is kept). This will ensure a level playing field between standardised and IRB approaches and address the criticism of overcompensation.

iii) **The EBF proposes that in the period from 1 January 2018 to 31 December 2019 a bank should include in CET 1 capital an adjustment amount of 100 % (coefficient 1)**. Offsetting the impact in capital is desirable, at least until a stable implementation and better understanding of the interaction between accounting and capital measures is achieved.

We believe that the neutralisation period is important to:

- Provide time to enable regulators to understand and consider the impact of the revised accounting frameworks, including the impact in stressed conditions, and its interaction with the prudential capital framework

- Allow entities, auditors, regulators and supervisors to achieve a sensible calibration of the triggers and thresholds to move assets from stage 1 to stage 2 and understand manage any differences in implementation between institutions

- Enhance a level playing field with US and other internationally active banks that are not under IFRS and that will not implement similar changes until 2020 at the earliest.

iv) **Finally, concerning the application of the transitional arrangements, we believe this should remain at the individual discretion of each credit institution**. Some institutions may decide not to apply transitional arrangements on the basis that the impact would not be significant. Alternatively, the application of the transitional arrangements should be mandatory with each credit institution having the ability to opt out from its application.

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About EBF

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