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Banks' IFRS 9 provisions to face first challenge with COVID-19

Many banks went live with their models and systems for IFRS 9 provisioning more than two years ago. Now, the new accounting standard and the banks' implemented methods to comply with it will face their first serious challenge following the global outbreak of Coronavirus (COVID-19).

"Too little, too late" was the often-cited justification to abandon the former accounting standard (IAS 39) and move toward IFRS 9. The latter introduced a forward-looking expected credit loss model as the basis of provisions for assets under the amortized cost and fair value through other comprehensive income classifications.

As governments and central banks around the world intervene to deal with the economic disruption and support activity, financial markets continue their instability. While some sectors will show resilience, the impact will be more severe and immediate in many sectors of the economy (for example, passenger airlines and shipping)[1]. In fact, the increase in credit risk is already significant for many firms, relative to exactly one year ago (Figure 1).

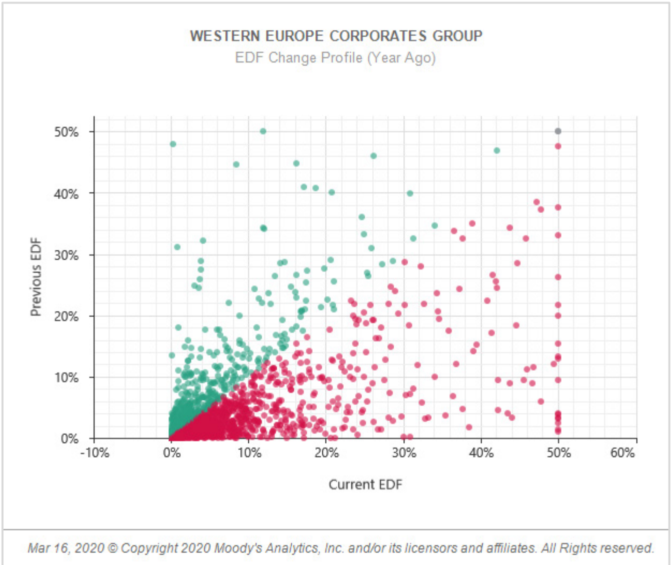
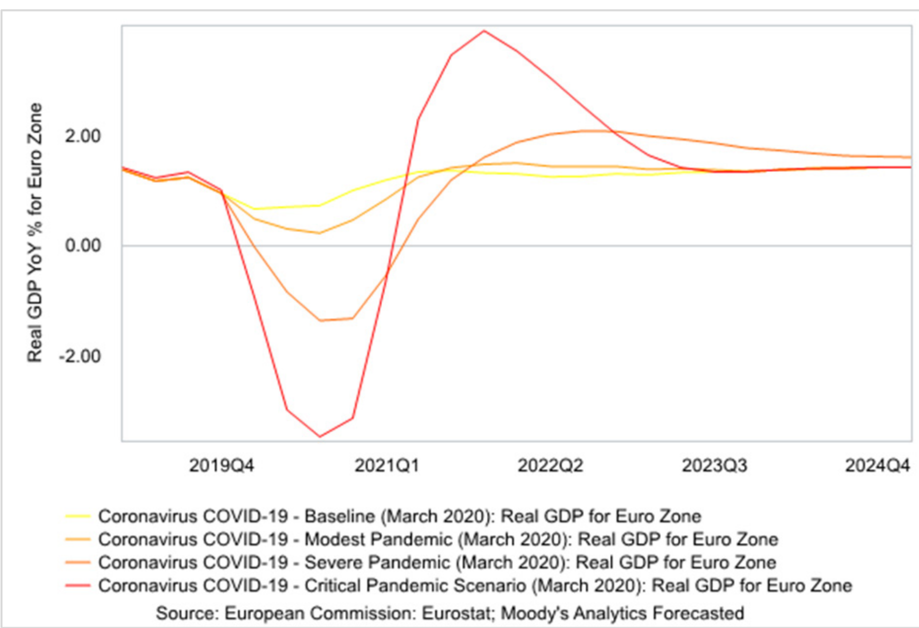


Figure 1: Change of credit risk as measured by the Expected Default Frequency (EDF) (Sample: More than 4,000 firms across Western Europe).[2]

This increase is important because IFRS 9 stipulates that provisions are estimated based on the expected credit loss for the entire remaining life of the financial instrument, such as loans to borrowers whose credit risk has increased significantly since origination. Banks and other institutions with exposures to borrowers in highly affected sectors will likely see the volume of provisions increase dramatically based on this transition of still-performing assets.

Furthermore, economists are now also expecting conditions to keep deteriorating, as reflected in their updated forecasts (Figure 2). This development is relevant because IFRS 9 provision calculation methods, by design, account for not only the current conditions but also expectations about future economic conditions (for example, economic forecasts).

Figure 2: Eurozone Growth Forecast Scenarios for COVID-19[3]



The situation may be exacerbated if some borrowers default suddenly as they may become unable to fulfill their financial obligations. Such defaults could result from the severity of the shock on the supply and/or demand side of their businesses.

The impact on each bank's provisions will differ based on credit portfolio composition, exposure to highly affected sectors of the economy, and the specific methods used to calculate provisions among other factors. However, one aspect remains clear: the provisions are expected to increase because of a combination of the drivers described in the preceding section.

According to a recent sector comment,[4] "the Coronavirus outbreak will have a direct negative impact on the asset quality of rated financial institutions and on the underwriting of insurers. Global monetary easing and related initiatives will help to relieve liquidity pressures but will weigh on profitability across the financial sector and will weaken some insurers' capitalization. Rated financial institutions particularly at risk include undiversified banks with material exposure to high-risk sectors, …and credit insurers with material exposure to small and medium-sized enterprises (SMEs)."

In a press release on March 11, 2020, the Governor of the Bank of England announced that the Financial Policy Committee reduced the United Kingdom's countercyclical capital buffer rate to 0% of banks' exposures to UK borrowers with immediate effect. This move further supports banks' abilities to supply the credit needed to get through this period of economic disruption. It was also suggested that the resilience of the core banking system, which has been strengthened significantly, should allow banks to support businesses and households that need credit.

The expected increase in IFRS 9 provisions will directly affect banks' capital levels—although programs to transfer credit risk to the state's balance sheet will probably help. What is unknown is the specific implications for each bank and the validity of authorities' assurances that the capital cushion will be sufficient during this period.

To address such challenges, the Bank of England already announced[5] several policy measures on March 20, 2020. Regarding the importance of and impact on IFRS 9, the Bank of England noted the following: "Given the sudden onset of the virus, the PRA believes that there is very little such [reasonable and supportable] information available as yet, and regards the preparation of reliable and detailed forecasts as very challenging currently. In the event firms believe that such forecasts can be made, the PRA expects firms to reflect the temporary nature of the shock, and fully take into account the significant economic support measures already announced by global fiscal and monetary authorities."

The European Central Bank (ECB) also made a similar announcement[6] encouraging "banks to avoid excessive procyclical effects when applying the IFRS 9 international accounting standard."

These highlight the importance of qualitative overlays and judgment, which need to be exercised over the outcome of models designed to calculate provisions. These overlays include the mechanisms to determine the stage of the financial instrument. Banks reporting under IFRS will be seeking further guidance from regulators in this matter while finalizing Q1 2020 numbers.

In addition, there may be interesting developments in the following areas:

» How will the banks' systems, inputs, and models cope with the provision calculations in the current volatile environment?

» Has IFRS 9 addressed the "too little, too late" criticism of its predecessor IAS 39, the incurred loss method?

We will continue watching developments to see how events will pan out. However, one thing is already clear; COVID-19 has various implications across industries—and more will follow. Thus, we will closely monitor the impacts on financial service organizations.

Links from the article:

- » [1] Moody's Investors Service Sector In Depth: Heat map: Coronavirus hurts travel-driven sectors, disrupts supply chains, effects compounded with global spread
https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1219094
- » [2] www.creditedge.com
- » [3] www.economy.com
- » [4] Moody's Investors Service Sector Comment, 17 March, 2020: Coronavirus and oil price shocks: managing ratings in turbulent times
https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1219246
- » [5] Bank of England announces supervisory and prudential policy measures to address the challenges of Covid-19
https://www.bankofengland.co.uk/news/2020/march/boe-announces-supervisory-and-prudential-policy-measures-to-address-the-challenges-of-covid-19
- » [6] ECB Banking Supervision provides further flexibility to banks in reaction to coronavirus
https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200320~4cdbbcf466.en.html

Additional resources from Moody's and Moody's Analytics:

- » Moody's Knowledge Portal on COVID-19
https://www.moodys.com/Coronavirus