

# The new accounting standard: pros and cons

Diario Expansión (Spain)

Javier Villar

20 Nov 2017

The global financial crisis revealed that the banks had not got the resources sufficient to handle a recession as far-reaching as it turned out to be, of a magnitude only comparable with the Great Depression of the 1930s. To prevent anything similar from happening again, the G20 sponsored new accounting rules in creating new banking provisions known as IFRS 9.

The principal innovation of IFRS 9 is to substitute incurred losses with a new expected losses criterion for estimating the value impairment of portfolios and related provisions. This means that the models for calculating provisions must incorporate not only data from the relevant variables for their calculation (for example, NPA), but also their forecasts for the relevant financial and macroeconomic variables. The aim behind this early recognition of potential future losses is to improve financial stability through greater transparency, market discipline or by bringing about rapid intervention by supervisors. That being said, this may have some undesired effects because of the impact on the regulatory capital, with banks potentially having diminished credit capacity at the start of a negative stage in the cycle. This could contribute to worsening the crisis, in producing effects that amplify the cycle: lending criteria could grow more conservative and limit the increase of provisions.

A number of studies have estimated the additional provisions which the bank would have to make in order to comply with IFRS 9 by early 2018 (for example, the recent evaluation of the impact of the European Banking Authority). A recent study by BBVA Research also looks into the secondary effects of the new rules. The banks will have to publish, in a transparent way, which case scenarios they are using in preparing their forecasts. However, each bank will be able to use their own assumptions and models, a factor will make it more difficult to compare institutions. While observing greater provisions in one bank compared to another (in relative terms) may indicate that this bank holds weaker assets, it may also signal that this bank is predicting a greater hike in unemployment figures as part of its models, or that the negative growth of macroeconomic variables will have a more notable impact on their balance sheet, or a combination of all of the above.

All of which could produce pro-cyclical effects. When the quality of credit deteriorates considerably, even without entering default, this must be classified under “Stage 2” and provisions must be made for the expected loss over the lifetime of the product. Such provisions will be much greater than the expected loss over the course of a year, equipped for the unimpaired loans (in “Stage 1”). Moreover, the reclassification of loans also depends on the assumptions applied by each bank, which are also amplified by the “recent behaviour trend”: at times of difficulty, forecasts are normally more pessimistic than the actual outcome, while when times are good, there is greater optimism.

Ideally, the hope would be for an overall neutral effect over the entire cycle. That said, the reality is quite likely to prove different. With a fledgling crisis, the banks will have to bring forward the relevant provisions for the next three to four years, yet the same cannot be said for the income expected for those years, revenue that will offset the impact of those losses. This advance accounting of potential losses may ultimately erode

both the profit and loss account, and diminish the capital position. Volatility in profits and dividends could impact significantly on investor confidence and the cost of capital. In extreme cases, the books could identify perfectly viable banks as being insolvent.

To prevent such negative scenarios, banks and supervisors will have to adopt compensatory measures. Monitors must ensure that the new rules are applied in a strong and harmonised manner across all institutions, and they could use regulatory capital buffers to stem excessive pro-cyclical effects. The banks will have to communicate properly on the source of the increased provisions, and temporarily maintain the old system alongside the new one, so that investors can distinguish between the effects of accounting and genuine impairment in the balance sheets. And while the banks are gearing up for this, the clock is winding down.

This document has been prepared by BBVA Research Department, it is provided for information purposes only and expresses data, opinions or estimations regarding the date of issue of the report, prepared by BBVA or obtained from or based on sources we consider to be reliable, and have not been independently verified by BBVA. Therefore, BBVA offers no warranty, either express or implicit, regarding its accuracy, integrity or correctness.

Estimations this document may contain have been undertaken according to generally accepted methodologies and should be considered as forecasts or projections. Results obtained in the past, either positive or negative, are no guarantee of future performance. This document and its contents are subject to changes without prior notice depending on variables such as the economic context or market fluctuations. BBVA is not responsible for updating these contents or for giving notice of such changes.

BBVA accepts no liability for any loss, direct or indirect, that may result from the use of this document or its contents.

This document and its contents do not constitute an offer, invitation or solicitation to purchase, divest or enter into any interest in financial assets or instruments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

In regard to investment in financial assets related to economic variables this document may cover, readers should be aware that under no circumstances should they base their investment decisions in the information contained in this document. Those persons or entities offering investment products to these potential investors are legally required to provide the information needed for them to take an appropriate investment decision.

The content of this document is protected by intellectual property laws. It is forbidden its reproduction, transformation, distribution, public communication, making available, extraction, reuse, forwarding or use of any nature by any means or process, except in cases where it is legally permitted or expressly authorized by BBVA.