IFRS9- Its impact on

(i) Earnings Volatility & Capital Management
and
(ii) Strategic Business decisions / processes

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IFRS9 – Its origin is found in the Global Financial Crisis

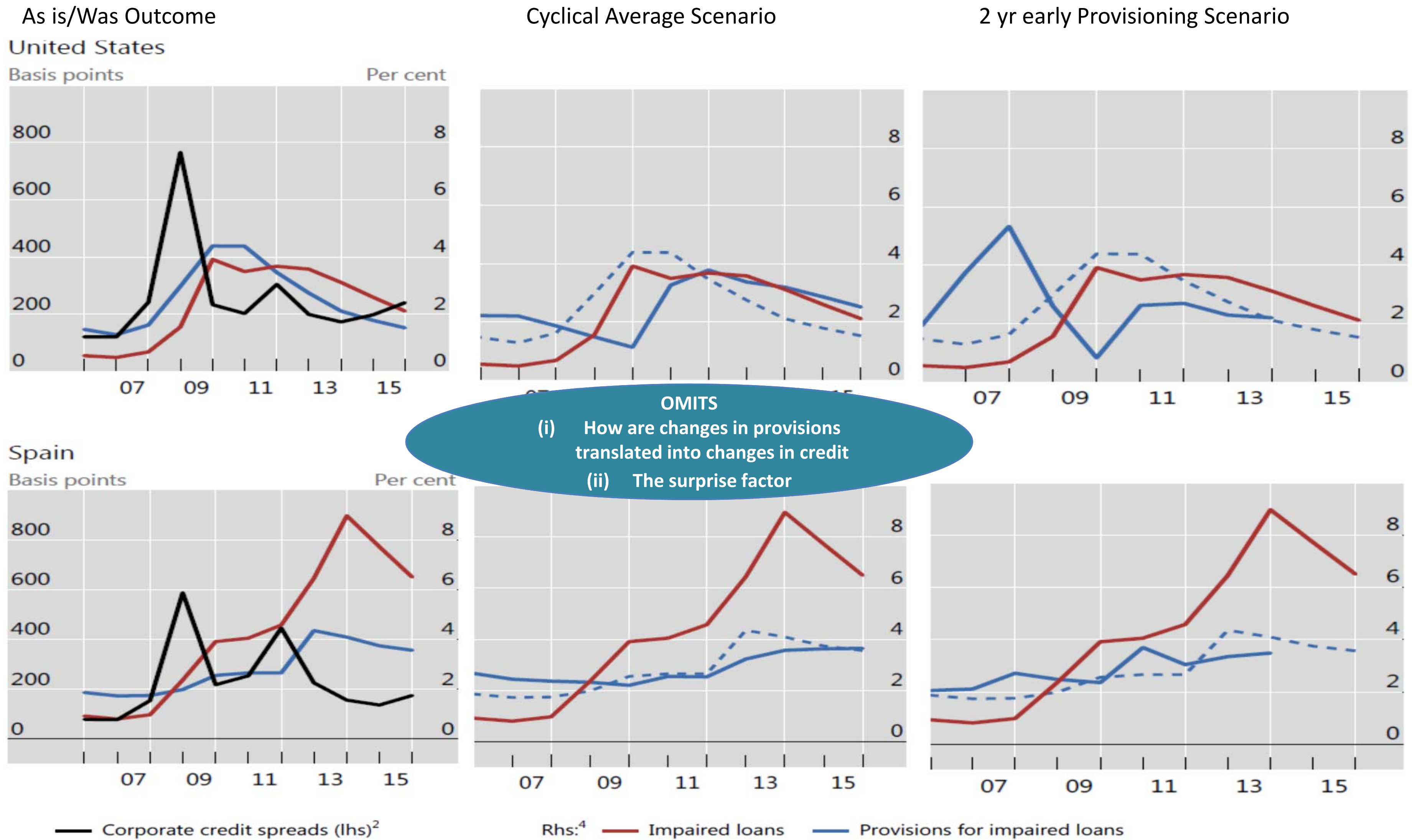
- The Crisis of 2007-09 highlighted the systemic cost of delayed recognition of credit losses on banks.
- Losses were recognised "too little too late"
- Provisioning models effect on Regulatory capital levels contributed to Procyclicality issues

  -Excessive lending during boom times
  -Sharp reduction in lending during bust

Move from "incurred loss model"
(losses incurred at B/S date).

"expected Credit Loss standard"
(forward looking approach)

Proper assessment with full range of future risks accounted, reduces pro-cyclicality.



Sources: Cohen Benjamin, Edwards Gerald; *The new era of expected credit loss provisioning;* BIS Quarterly Review March 2017, Bank of America Merrill Lynch, Fitch Connect, above Author’s Calculations

IFRS9 and expectations

IF I ask you to compare your expectations on the state and prospects of the Cypriot economy and the banking industry in June 2013 versus the ones you had in June 2017, then would you choose.

(a) Agree that the expectation on the state and progress of the Cypriot economy and banking industry were **higher** in June 2017 versus June 2013.

OR

(b) They were the same.

Recency Bias: Expectations of the near future are frequently based on experiences of the recent past. A common cognitive bias we are all susceptible to.

IFRS9–Earnings Volatility & Cost of Capital implications exist under the new standard

- Material Day 1 impact.
- How judgements/expectations will change over time creates volatility in earnings and in capital management of institutions.
- Hidden risks emerging by the introduction of expected losses in financial assets need to be adequately understood and managed from the outset.

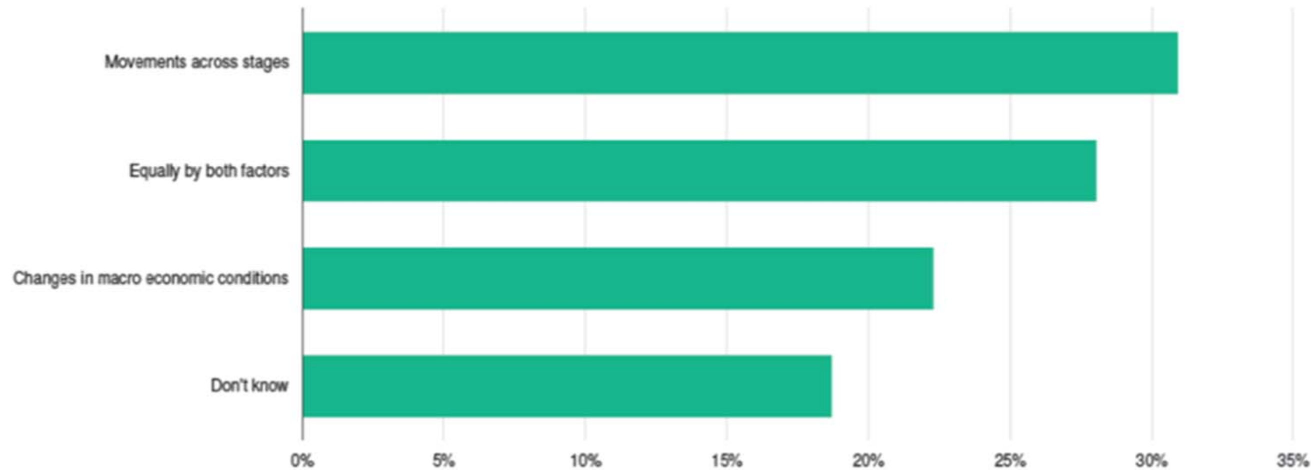
Impact - EBA up to 18% increase in cum provisions. Barclays Research expects stock of provisions to rise 20%-30%.

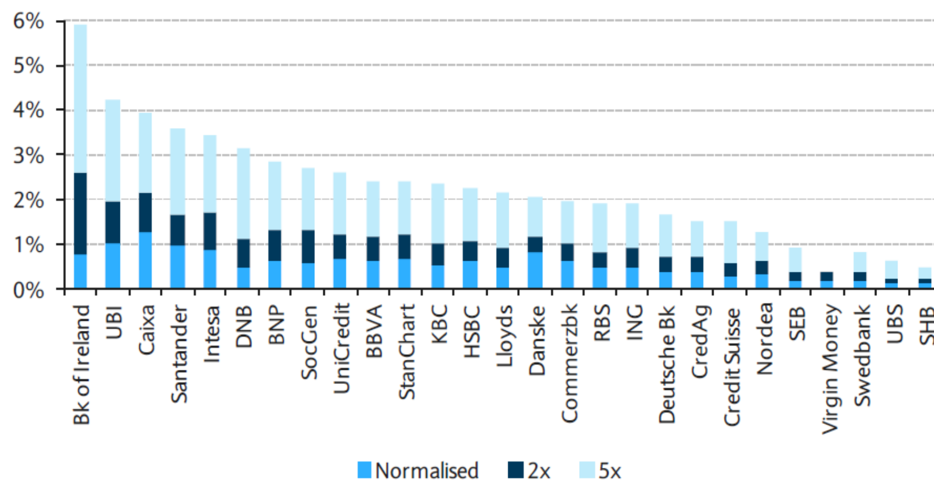
Pro-cyclicality of IFRS9 on both cost of capital and cost of credit at a time needed most by economies. “The cliff effect”.

Opaqueness in numbers followed by investors.

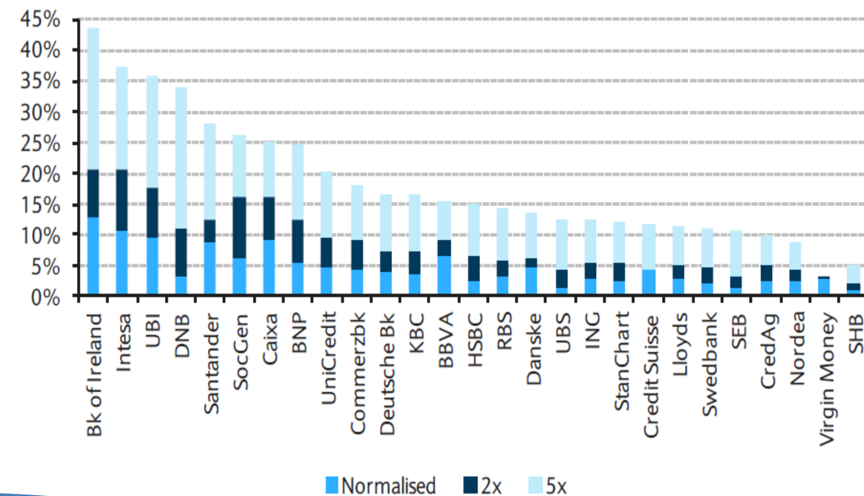
Correlation leading to added concentration.

Various reasons for income volatility with significant impact from Staging.





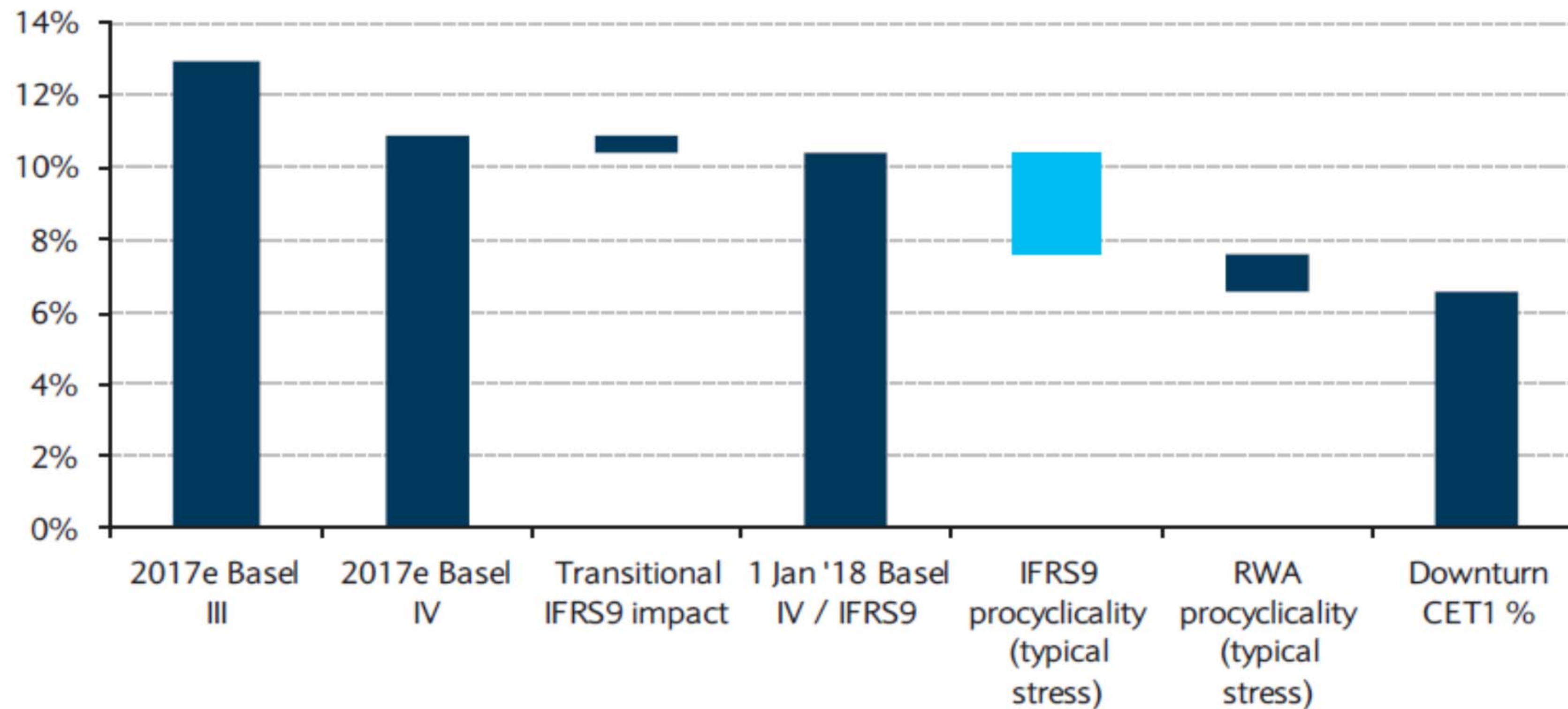
Source: Company disclosures, Barclays Research estimates



Barclays Research estimates

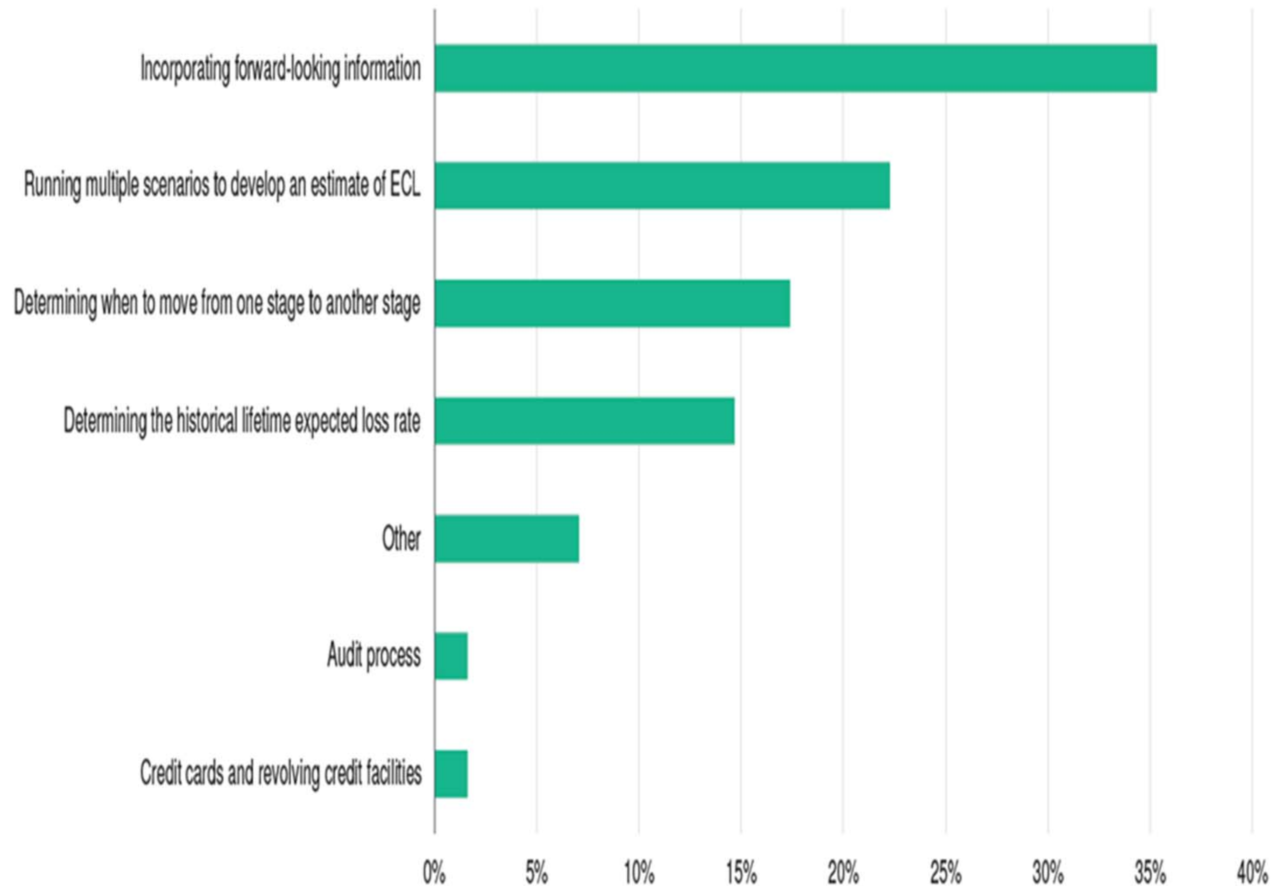
This is based on the observation that high yield default rates as a proxy to stage 2 credit quality commonly rise 2-5x above normalised levels.

Macro changes under stress coupled with staging can create significant CET1 impact.



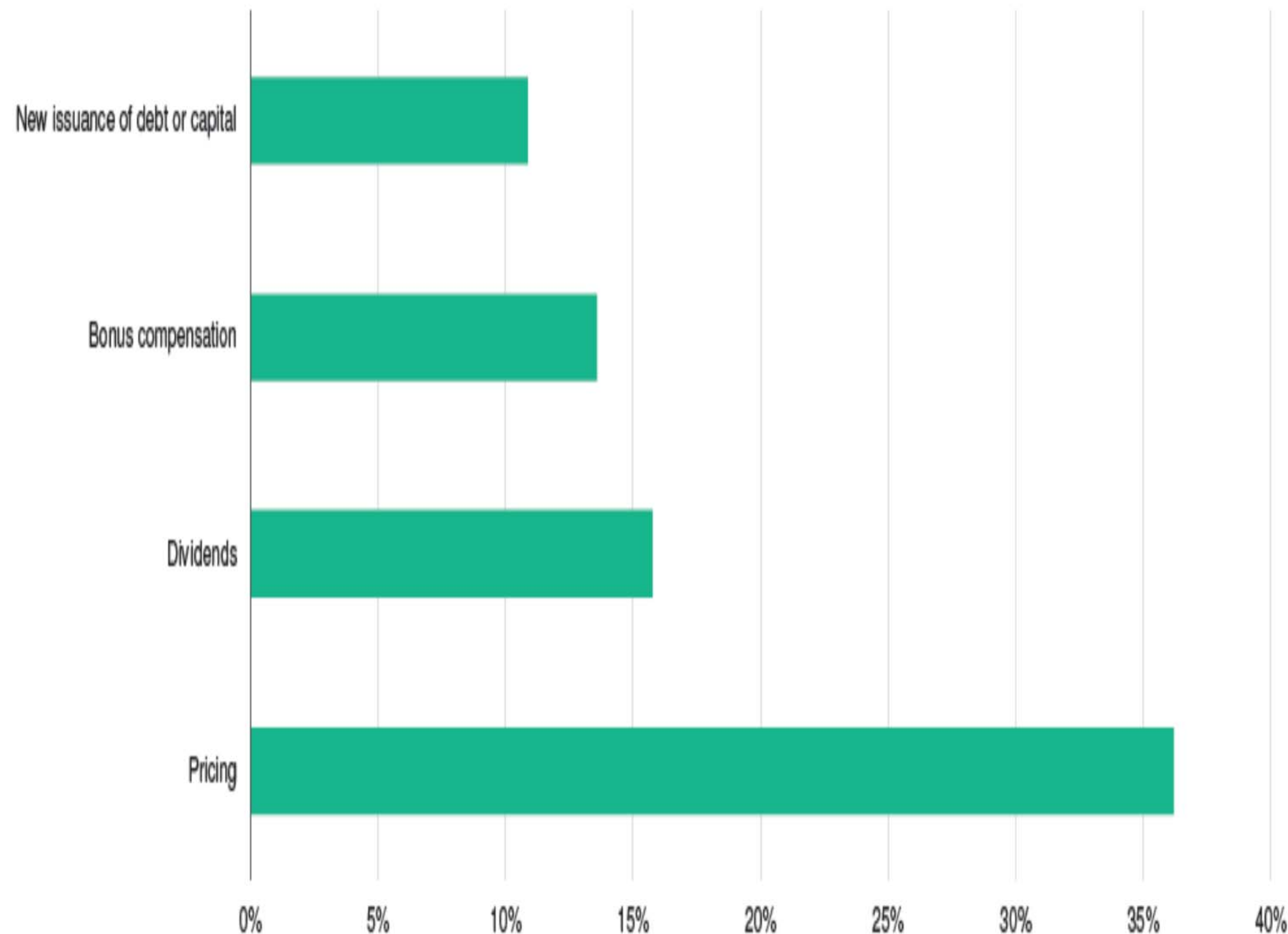
Market Research seems to show that pro-cyclicality and Volatility in earnings and capital requirements have not been eradicated.

IFRS9 implementation challenges: data, analytics, policies, processes.



- **Extensive additional modelling work forcing frontloading of investment in the area.**
- **Extensive remediation exercises to enhance Data availability and quality.**
- **Governance – Policies matter.**
- **Disclosure. Expectations**

IFRS9 strategic aspects need to be well understood by businesses



The way we measure credit scoring

The way we assess & originate credit related business.

Focus on (i) more granular analysis of business lines, (ii) more stressing of business risk and (iii) improved monitoring of capital allocation.

Policies around expected loss calculations matter.

Regulatory level changes can not be ignored. (Basel 4, DDs RWA variability. etc.)

Dividend Policy and Remuneration/Performance assessment under IFRS9

The major themes of IFRS9 poses some interesting challenges

?	Does the IFRS9 approach represent a compromise between relevant information and catering for regulatory needs for greater financial stability.
X	Could the alignment of accounting and supervised rules create incentives to manipulate MCAR under CRR?
√	EBA efforts are crucial in harmonizing supervisory practices and in achieving a consistent application of the expected credit loss approach in supervised institutions
√	Is IFRS9 a catalyst for better analytics and better data availability especially in smaller banks?
X	Will IFRS9 likely to avoid added earnings and capital requirements volatility?
√	The Day 1 impact seems manageable where as thoughts for a phase-in approach will minimise impact.
√	Banks dealing with legacy issues will not necessarily be the most vulnerable in the next downturn.
X	Disclosure under IFRS9 poses its own challenges and introduction of expectations in earnings will need to be carefully addressed.

Thank You

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