UPDATE ON IFRS 9 & CECL

“Much Ado About Nothing” or “Après Moi, Le Deluge”?

As expected by many, the introduction of IFRS 9 has been no big deal. But the structural problems created by the new standard remain a significant threat to financial stability. Can industry apathy and political correctness be overcome, to mitigate the dangers of expected credit loss provisioning?

The views expressed in this note are the personal views of the authors and do not represent the views of BNP Paribas SA. Please read the disclaimer at the foot of this note.

Summary

- To the great credit of the thousands of professionals involved, IFRS 9 has gone live successfully.
- The one-off impact of the new standard is immaterial. The market is, on the whole, disinterested. New, complex disclosures have been largely ignored. The go-live has been an anti-climax.
- Market apathy will persist until stressed provision levels are observed.
- The dangers of ECL provisioning (procyclical volatility, complexity and subjectivity) have been confirmed by the authorities...
- ...But criticism of IFRS 9 is politically incorrect. The ESRB’s concerns about financial stability have been masked and the BoE’s part-neutralisation of lifetime ECL provisions in this year’s stress test has been clumsy.
- Regulatory adaptation has been limited to transition rules, which are not a solution. We need a fundamentally revised Basel regime – “Basel V” – in which lifetime ECL provisions somehow offset regulatory capital requirements.

Recap of key points from prior notes 1,2,3,4,5,6:

- Despite the best intentions of the authorities, the introduction of Expected Credit Loss (ECL) accounting is a bad development for the industry and the market. It brings increased complexity, subjectivity, volatility and procyclicality in loan loss provisioning. Accounting information becomes less meaningful.
- The market was insufficiently prepared. Impact studies gave scant information and focused on the one-off solvency impact not the ongoing challenges.
- As the 2018 IFRS 9 go-live approached, banks were frantically focusing on implementation projects to deliver the numbers.
- Slowly, and in part thanks to the BNP Paribas 3-minute cartoon video7, the industry was becoming more aware of how IFRS 9 works and its ramifications.
- Initial data were indicating a milder one-off impact than feared – perhaps only 50bp hit to CET1 and no banks decimated.
- With “impact” discussions focusing on the initial hit to CET1, the real villain of the play – future procyclical volatility – was neglected. Few banks had begun to consider the strategic impacts of IFRS 9 and CECL.
- Work on integration into regulatory capital frameworks was at an early stage and limited to authorities defining transition rules: phase-in rather than neutralisation. Banks, on the other hand, objected to a perceived double count and wanted CET1 credit for excess provisions, as well as a period of neutralisation until Basel defines the fit with reg-cap.

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1 Funny Mirrors: The Strategic Impact and Unintended Consequences of IFRS 9, Key Points for Banks, Investors and Regulators, BNP Paribas Bank Advisory, 16 July 2015
2 Update on IFRS 9: Get over it!, BNP Paribas Bank Advisory, 8 October 2015
3 Update on IFRS 9: Countdown has begun..., BNP Paribas Bank Advisory, 1 April 2016
4 Update on IFRS 9: Too Late for Cold Feet, BNP Paribas Bank Advisory, 15 August 2016
5 Update on IFRS 9: You aren’t going to like it: Forty-Two, BNP Paribas Bank Advisory, 14 October 2016
6 Update on IFRS 9: It might be a good thing, let’s give it a try!, BNP Paribas Bank Advisory, 27 March 2017
7 tinyurl.com/ELCartoon and bit.ly/2jDsoGD
Since our last update memo for clients in March 2017, largely unseen – but hopefully not unsung – heroes in Risk, Finance and IT functions have pulled off what must once have seemed an impossible feat and delivered their financial statements under IFRS 9. Yes, there are many workarounds and compromises that will be improved over time. But by-and-large, the projects have achieved their monumental goals. Woohoo!

The “glass half empty” side of this observation is that banks have had to ruthlessly focus their resources on implementing the standard on time, which, to put it mildly, has not been trivial. There has been little time to navel-gaze and reflect upon policy issues. This is a shame but it is also a reality. Hopefully that deficiency can now be overturned.

Before reviewing the new numbers and what they mean, it is worth briefly recapitling on the main policy and analytical developments that happened over the last year.

On 13 July 2017, the EBA published an updated impact study\(^8\), following on from the one it had published nine months earlier. Recall that the media fixated upon the key finding in November 2016 that the average impact of first-time adoption of IFRS 9 for European banks was estimated at 59bp hit to CET1 ratios. The hit was over 75bps for 21% of banks. In the updated study, the estimated impact had decreased: “It is estimated that the CET1 ratio will decrease, on average, by 45 bps (59 bps decrease in the first exercise), and by up to 75 bps for 86% of respondents (75 bps decrease for 79% of respondents in the first exercise)”. EBA reported also that the outliers are small banks and for large banks, the median hit to CET1 ratios was estimated at 33bp.

<table>
<thead>
<tr>
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<th>First Impact Study</th>
<th>Second Impact Study</th>
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<tbody>
<tr>
<td>Average Hit to CET1</td>
<td>59bp</td>
<td>45bp</td>
</tr>
<tr>
<td>Proportion of Banks with Hit to CET1 in excess of 75bp</td>
<td>21%</td>
<td>14%</td>
</tr>
</tbody>
</table>

Later in the year, the SSM put out its report on IFRS 9\(^9\). The observations on preparedness were less than scintillating (eg. “for some institutions there is still room for improvement if a high quality implementation of IFRS 9 is to be achieved”), but the ECB reminded us that the thematic review itself generated a beneficial Hawthorne effect: “this initiative, as well as the launch of the thematic review itself, has contributed to an increase in the institutions’ awareness of the challenges associated with

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\(^8\) EBA Report On Results From The Second EBA Impact Assessment of IFRS 9, EBA, 13 July 2017  
\(^9\) SSM thematic review on IFRS 9: Assessment of institutions’ preparedness for the implementation of IFRS 9, European Central Bank, November 2017
implementing the standard. As a result, many of them have taken corrective measures and dedicated more resources to the project”. Let’s have more thematic reviews, please!

The quantitative results fitted with the EBA numbers reported above: the one-off IFRS 9 impact would be 40bp for large banks and 59bp for smaller banks. However, the SSM gave a more detailed distribution profile than the EBA had, showing that 8% of large banks expected a hit to CET1 ratios in excess of 100bp.

Outside Europe, pre-implementation impact studies were harder to come by. One pan-Asian study was the one conducted by Regulation Asia in association with S&P Global Market Intelligence. They reportedly surveyed 189 respondents in 13 countries in Asia, although the size/sector/geography profile is not clear. Nevertheless, the publication reports that banks are “in the process of refining a number, but expected a drop of between 150-200 basis points in their capital adequacy ratios”10.

Patchy reports from the press and ratings agencies led us to believe that the one-off impact of IFRS 9 on CET1 solvency ratios was expected to be minimal in Hong Kong, Singapore and Australia, largely due to the practice in those jurisdictions of applying a mandatory loss reserve for all exposures.

Throughout 2017, arguably the most interesting, even exciting, commentary on IFRS 9 came from the Bank of England (BoE).

On 20th September 2017, the BoE’s Financial Policy Committee said that its “judgement of the necessary level of loss absorbing capacity for the banking system is invariant to accounting standards. The change in accounting standard will not, by itself, change the cumulative losses banks incur during any given stress episode. The Committee’s judgement of the appropriate level of capital for the banking system was calibrated such that banks could absorb the cumulative losses in historical stress episodes and continue to provide essential services to the real economy, regardless of the timing of when those losses were actually measured [...] The FPC will take steps to ensure that the interaction of IFRS 9 accounting with its annual stress test does not result in a de facto increase in capital requirements”11. This was very encouraging – a recognition that the new accounting standard does

10 IFRS 9 Regional Insights: 2017 Asia Pacific Market Survey, Regulation Asia in association with S&P Global Market Intelligence, June 2017
11 Financial Policy Committee Statement from its policy meeting, Bank of England, 20 September 2017
not *per se* reduce the solvency of the banks in question. More optimistically, we took it as a sign that the authorities view forward-looking provisions as capital-like in their nature.

We got further excited when we read that “the FPC and Prudential Regulation Committee (PRC) encourage firms to use any internationally agreed transitional arrangements as they adjust to the new regime, provided the arrangements are broadly similar to those currently being considered. The FPC and PRC will respect firms’ choices in future capital assessments and stress tests”\(^\text{12}\). Even to a local native English speaker, this is a confusing message, but it seemed to indicate that the authorities want banks NOT to incorporate “fully-loaded” metrics into their business planning and strategy. Could it mean that the Bank of England is confident that the end-game for IFRS 9 provisions will be an add-back of excessive provisions to CET1 resources?

In November 2017, the Bank of England released the public results of its 2017 stress test\(^\text{13}\). The test had an IFRS 9 “exercise” running alongside in parallel. We had expected a small amount of high-level, aggregated information to come out of this, based on the instructions on how to incorporate IFRS 9 that had been issued in May\(^\text{14}\): “The Bank has committed not to disclose firm specific IFRS 9 data. Consideration of information that may be disclosed will be decided in due course”. In the end, however, the market got nothing. A handful of nerds – up early on 28 November, repeatedly hitting F5 to get the document immediately upon its release at 0700 – were disappointed.

Three months later, however, the nerds got what they were waiting for: a bombshell of a paper\(^\text{15}\) from the BoE, setting out the way that it would treat IFRS 9 in the 2018 stress test for UK banks. In this paper, the BoE appeared to stick to its earlier promise to not allow IFRS 9 to create a *de facto* increase in capital requirements:

> “The change in accounting standard does not, other things equal, change the total amount of losses a bank would incur through a given stress”

Would it do this by adding back extra IFRS 9 provisions for stage 2 LEL to CET1 resources? No. Instead, the BoE took the less coherent approach of lowering the hurdle rate or “pass mark” of the stress test:

> “Recognising the increased loss absorbency that will result from higher provisions in stress under IFRS 9, the FPC and PRC intend to use the information provided by the 2018 stress test to make adjustments to the hurdle rates against which banks’ performance in this year’s test is assessed. Applying the same stress scenario as in the 2017 ACS will allow the Bank to estimate the impact of this accounting change.”

Total credit impairments in the 2017 test were £145bn. If, under IFRS 9, £60bn of those provisions get front-loaded into the first year of the stress, in addition to the provisions that were already booked in the first year, this would be equivalent to 3% of RWAs. This doesn’t seem like an unreasonable assumption. So, we could expect a 3pp reduction in the hurdle rate, on average.

However, there is a hitch. The BoE’s adjustment of hurdle rates will be limited to the extent they do not breach Pillar 2a:

> “No bank should have a hurdle rate after any adjustment that is below its minimum risk-weighted (Pillar 1 plus Pillar 2A) capital and leverage ratio requirements”

In practice, this means that only the systemic buffers can be removed from the pass mark. Other capital requirements – the capital conservation buffer (2.5% RWAs) and the PRA buffer (confidential) – aren’t in the hurdle rate to start with. But in the UK, the systemic buffers are typically between 1% and 2% of RWAs for large banks.

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\(^\text{12}\) Financial Policy Committee Statement from its policy meeting, Bank of England, 20 September 2017

\(^\text{13}\) Stress testing the UK banking system: 2017 results, Bank of England, November 2017

\(^\text{14}\) Instructions for completing the IFRS 9 exercise running alongside the 2017 concurrent stress test, Bank of England, May 2017

\(^\text{15}\) Stress testing the UK banking system: key elements of the 2018 stress test, Bank of England, 1 March 2018
It seems that the aggregate impact of IFRS 9 ECL provisions in the stress test will be greater than the maximum permitted reduction in hurdle rates – when those provisions are fully loaded.

“The Bank will assess participating banks’ results on a transitional basis”

The impact of IFRS 9 will be muted by transitional arrangements rather than any add-back of incremental provisions or commensurate (rather than partial) reduction in the hurdle rates. The transitional arrangements can be seen through and are, by their very nature, temporary. It really seems as though the BoE has failed to make good on its promise to stop IFRS 9 resulting in a de facto increase in capital requirements in the stress test.

Three other nuggets of insight came from this BoE paper.

The first was the instruction that banks should assume “perfect foresight” in their stress test calculations, in other words that the economy evolves in line with given assumptions from the start of the stress, rather than assuming uncertainty. Perfect foresight has become the standard way to model stress under IFRS 9 in public stress tests, but it is controversial (see below).

The second was the practical expedient that banks should model only one scenario in their IFRS 9 models, rather than adjusting for skew by considering a range of more and less severe possible scenarios.

The third insight disbursed by the BoE in this memo was a good illustration of the procyclicality of ECL provisioning in a stress.

**BoE illustration of the impact of IFRS 9 on a bank’s capital resources during a stress scenario**

The BoE admitted that “capital will fall more sharply and then recover more rapidly”. On the other hand, it rapidly followed that up with the politically correct assertion that “not only will this earlier recognition of losses ensure greater transparency about banks’ exposure to a downturn, IFRS 9 will also support financial stability”. Ironically, the BoE thereafter sets out its clumsy and temporary hurdle rate adjustment. The BoE stance overall is not coherent. Are they trying to make IFRS 9 capital-neutral or not? They say one thing, and do another. It’s confusing.

As B.B. King put it in 1943 (oh, and Shakin’ Stevens in 1985): “Is you is, or is you ain’t?”
Implied BoE stance on IFRS 9 provisioning

| Does the implied BoE stance mean that IFRS 9 will increase capital requirements – or not? Does it fit more with viewpoint 1 or viewpoint 2? |
| --- | --- | --- |
| Viewpoint 1 | Implied BoE stance | Viewpoint 2 |
| “Change in accounting shouldn’t lead to an increase in capital requirements” | Provisions charge in P&L and reduction in book equity (note: required expressly so that financial resources are increased in a timely fashion) | “Change in accounting leads to real-world change in capital needs” |

<table>
<thead>
<tr>
<th>Forward-looking loss estimate impact on financials</th>
<th>Information note only</th>
<th>Provisions charge in P&amp;L and reduction in book equity (note: required expressly so that financial resources are increased in a timely fashion)</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Regulatory CET1 capital</th>
<th>Add-back of “excess” provisions to regulatory CET1 base</th>
<th>No adjustment</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Regulatory RWAs</th>
<th>Reduction in RWAs equivalent to excess provisions x 12.5</th>
<th>No adjustment</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Capital requirements</th>
<th>Recalibrated without reference to “excess” provisions</th>
<th>No adjustment</th>
</tr>
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<tr>
<th>Stress test hurdle level</th>
<th>Reduced by the amount of “excess” provisions</th>
<th>Reduced by the amount of “excess” provisions, to a certain extent</th>
</tr>
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EBA Stress test 2018

The EBA stress test for 2018 is an EU-wide exercise and the methodology is set out in a note. How should banks model their forward perspectives under a hypothetical stress?

- Single rather than multiple scenarios
- Perfect foresight on macroeconomic projections (“at any point of time in the projection banks should assume the subsequent path of a variable to be known and equal to what is given in the scenario for the remaining maturity of the exposure”)
- Mean reversion in perpetuity (“For the estimation of lifetime ECL, after the end of the scenario horizon, the adverse scenario credit risk parameters [...] are assumed to revert to the baseline horizon credit risk parameters. The baseline credit risk parameters are assumed to stay flat after year 3”)

Since the EBA stress test for 2018 does not have a hurdle rate or “pass mark”, the performance of banks is largely informational. Banks will need to disclose the results on both a transitional and a fully-loaded basis.

On 17 July 2017, the European Systemic Risk Board published a thoughtful report on IFRS 9 and its impact on financial stability. It is a must-read. Whilst always toeing the Party line on the overall

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16 Letter from Nout Wellink, Chairman Basel Committee, to FASB re “Financial Crisis Advisory Group’s Request for Comment”, 8 April 2009
17 Letter from Nout Wellink, Chairman Basel Committee, to FASB re “Financial Crisis Advisory Group’s Request for Comment”, 8 April 2009
18 2018 EU-Wide Stress Test Methodological Note, EBA, 31 January 2018
19 Financial Stability Implications of IFRS 9, ESRB, 17 July 2017
desirability of ECL provisioning in general, it does highlight some of the many challenges in an honest and balanced way. The result is a tense and ambiguous position:

Is IFRS 9 clear and understandable? *Adequate disclosures will be vital.*
Is IFRS 9 procyclical? *There is a vast body of literature with mixed results.*

etc.

A summary of the ESRB’s gushing assessment using the ESCB’s framework is in Annex A below.

Beyond the framework-based assessment, the ESRB makes some adroit observations. Of course, they don’t make them directly: they use some of the most circumlocutory phrases you have ever read!

Below is an interpretation of what they say. *Please read the left-hand side column first. If our read is correct, then this is sensational.*
<table>
<thead>
<tr>
<th>What they mean</th>
<th>What they say</th>
</tr>
</thead>
<tbody>
<tr>
<td>IFRS 9 can be good for financial stability</td>
<td>“Stronger initial caution and earlier corrective action have the potential to contribute to financial stability and make banks’ lending activity less cyclically sensitive”  “If soundly implemented, IFRS 9 will enhance transparency and facilitate an earlier and fuller recognition of impairment losses, which has been found to have positive effects on financial stability through various channels”</td>
</tr>
<tr>
<td>But only if models are prescient</td>
<td>“The extent to which the ECL models of banks are able to anticipate downturns well in advance would determine the positive effects of the ECL approach on financial stability”</td>
</tr>
<tr>
<td>In fact, it’s hard to be anti-cyclical</td>
<td>“Banks do not currently have a track record of the predictive power of their ECL measurements on a PIT basis that could give regulators an indication of the banks’ forecasting capacity”</td>
</tr>
<tr>
<td>More capital will be needed</td>
<td>“Anticipating the cyclical sensitivity associated with the new impairment regime and its impact on capital, banks may first adopt additional precautions such as carrying additional capital buffers with which to withstand potential rises in impairment allowances”</td>
</tr>
<tr>
<td>Loans prices and refinancing risk will increase, credit supply will be dampened</td>
<td>“An earlier and more decisive recognition of credit losses may contribute to market discipline, leading bank managers to adopt more prudent and less cyclical lending strategies in the first place”  “Under ideal conditions, loan rates should reflect potential credit losses over the lifetime of the contract and the price of unexpected losses that cannot be diversified, irrespective of the accounting standard in place. [...] Imperfections may lead banks to charge higher rates on some of their loans (e.g. long-term loans)”  “banks may decide to shorten the maturity of their loans (possibly in combination with a semi-automatic roll-over policy for loans)”</td>
</tr>
<tr>
<td>IFRS 9 is procyclical</td>
<td>“The PIT nature of the new expected loss approach may imply that impairment allowances increase suddenly and significantly if aggregate economic indicators deteriorate significantly”  “IFRS 9 will imply impairment allowances that are on average larger and, as expected, will react sooner and more strongly to changes in the cyclical state of the economy”  “Empirical data “do not allow the risk to be ruled out that, contrary to its intent, IFRS 9 may, in certain circumstances, amplify rather than dampen the variability of capital pressures over the business cycle, with the potential well-known implications for the cyclicality of credit supply”</td>
</tr>
<tr>
<td>Procyclicality is destructive</td>
<td>“The potential procyclical effects may take the form of asset sales, a contraction of new lending or the spreading of distrust regarding banks’ financial health and their capacity to serve their lending function. If this effect is systemic and many banks are affected at the same time, the aggregate implications might be a credit crunch and a deeper contraction of the economy, which in turn may affect the system in the form of even higher default rates and LGDs among bank borrowers”</td>
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<tr>
<td>Prescience would help</td>
<td>“If the downturn or its implications can be sufficiently anticipated, procyclicality may be reduced and the credit contraction in a downturn may be less severe”</td>
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<tr>
<td>Excess provisions should be treated as CET1</td>
<td>“For IRB banks, if the capital requirements are intended to preserve their foundational risk-management logic, prescriptions regarding the requirement to deduct provision shortfalls from CET1 capital and the permission to add back excess provisions in the form of Tier 2 capital up to specific limits may need to be revisited following the change in accounting provisions”</td>
</tr>
<tr>
<td>But neutralisation is politically incorrect</td>
<td>“Adjustments that appear, from a regulatory perspective, to amend or compensate for the greater forward-looking nature of impairment allowances under IFRS 9 may seem to contradict the mandate of the G20 regarding the desirability of more forward-looking provisioning practices.”  “It could result in a confounding message to the users of the accounting statements regarding the relevance or reliability of accounting capital or of accounting figures in general”  “The EBA is sceptical of any proposal of a complete prudential neutralisation of stage 1 provisions over a certain period of time, as the supervisory community has welcomed the introduction of IFRS 9 to the EU and expects that institutions will be sufficiently prepared for the initial application of IFRS 9, given that this change has been expected for some time”</td>
</tr>
<tr>
<td>Implementation has been painful</td>
<td>“This significant investment in IT and human capital must be undertaken during a period in which banks are still struggling with legacy problems from the recent global financial crisis and low levels of profitability”</td>
</tr>
<tr>
<td>Hard to say whether it will be a disaster</td>
<td>“The efficiency and the benefits of the new accounting standard for financial instruments will largely depend on how it is implemented in practice”</td>
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The ESRB report also delivered the results of some ground-breaking research. For the first time, the confusing hypothetical debate about procyclicality was transformed into an empirical, grounded and proven fact. The results of the research, according to the ESRB, “do not allow the risk to be ruled out that, contrary to its intent, IFRS 9 may, in certain circumstances, amplify rather than dampen the variability of capital pressures over the business cycle, with the potential well-known implications for the cyclicity of credit supply”. Even with four levels of caveat, the message is clear: “Contrary to its intent, IFRS 9 amplifies rather than dampens the variability of capital pressures over the business cycle, with the well-known implications for the cyclicality of credit supply”. Or, translated even more simply, expected loss accounting has dangerous procyclical effects.

EU transition

In November 2017, the European authorities finalised their transition rules for IFRS 9. The approach is “dynamic” – meaning that the impact of IFRS 9 is re-calculated each period – and the fully-loaded figures are to be reported simultaneously.

EU Transition Schedule for Regulatory Capital IFRS 9 Add-Back

<table>
<thead>
<tr>
<th>Year</th>
<th>Add-Back</th>
<th>Effective Impact</th>
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<tbody>
<tr>
<td>2018</td>
<td>95%</td>
<td>5%</td>
</tr>
<tr>
<td>2019</td>
<td>85%</td>
<td>15%</td>
</tr>
<tr>
<td>2020</td>
<td>70%</td>
<td>30%</td>
</tr>
<tr>
<td>2021</td>
<td>50%</td>
<td>50%</td>
</tr>
<tr>
<td>2022</td>
<td>25%</td>
<td>75%</td>
</tr>
<tr>
<td>2023 on</td>
<td>0%</td>
<td>Full</td>
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US CECL status

The FASB CECL standard appears to be on track for implementation in two years’ time. For smaller banks who aren’t listed on an exchange, the implementation deadline is 31 December 2021.

On 14 May 2018, the US authorities published their proposal for the treatment of excess provisions and also the phase-in transitional approach (25% in year 1, 50% in year 2, 75% in year 3, 100% in year 4). They also clarified that they propose to change stress testing regulations so that banks would not include the effect of CECL on their provisioning for purposes of stress testing until the 2020 stress test cycle, even if they have already adopted CECL.

The TRG meeting on 11 June considered some detailed technical aspects and transition tweaks, such as allowing “a one-time election to apply the fair value option (FVO) to existing financial instruments upon adoption of Update 2016-13. This request would allow entities who choose to elect the FVO for instruments going forward to avoid having two different accounting models for their portfolios (that is, CECL and fair value)”.

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21 Regulatory Capital Rules: Implementation and Transition of the Current Expected Credit Losses Methodology for Allowances and Related Adjustments to the Regulatory Capital Rules and Conforming Amendments to Other Regulations, Federal Register, 14 May 2018
22 Transition Resource Group for Credit Losses, Cover Memo for 11 June 2018 meeting, FASB, 1 June 2018
It’s déjà vu all over again (yet another cri de cœur)

The publications summarised above strengthen our view that ECL provisioning is a bad development.

The authorities do not deny the challenges presented by the new accounting standards.

The ESRB and BoE publications confirm the procyclicality of IFRS 9 explicitly.

If IFRS 9 had been applied during the recent financial crisis, it would not have resulted in provisions being taken in the good times of 2006 or 2007. Instead, it would have resulted in a massively destructive provisions charge towards the end of 2008 because that’s when the objective indicators were at their most dire. This has been nicely illustrated by ING in their latest financial results:

The authorities also confirm the subjectivity and complexity of the new standard, though they don’t describe the difficulties that market participants are having in using or interpreting IFRS 9 numbers. They express vague ideas on how to resolve problems: the auditors will sort it out somehow and/or the market will somehow deal with it.

They know the challenges that have led to “Basel IV”: “the financial crisis highlighted a number of shortcomings related to the use of internally modelled approaches for regulatory capital, including the IRB approaches to credit risk. These shortcomings include the excessive complexity of the IRB approaches, the lack of comparability in banks’ internally modelled IRB capital requirements and the lack of robustness in modelling”24. So how can they go along with IFRS 9 and CECL?

In official documents, the authorities still cling to the assertion that ECL provisioning is good for financial stability “if soundly implemented” or “if properly applied”. They claim that the new standard “means that provisions for potential credit losses will be made in a timely way”25. But what they want is contrarian, anti-cyclical ECL provisioning. This is simply not possible, in part because of human psychology but, more importantly, because the standard requires justifiable projections based on objective, consensual evidence.

Surely the authorities know they are wrong? Their arguments don’t stack up.

They hide behind repeated statements that the G20 instructed them to deliver ECL provisioning, whereas a re-read of the actual instructions26 clearly shows that a procyclical, subjective and complex regime was not what was asked for.

It just doesn’t add up.

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23 First quarter 2018 Results, ING, 9 May 2018
24 High-level summary of Basel III reforms, Basel Committee, 7 December 2017
25 Stress testing the UK banking system: key elements of the 2018 stress test, Bank of England, 1 March 2018
**Advice and support has become a whole new sub-industry**

A few years ago, support materials on IFRS 9 impact and implementation were few and far between. Researchers and analysts seized upon new publications and reports, in the hope of gleaning new insights and fresh data. Now, the industry is awash with information, too much to catalogue, of variable quality and questionable use; much of the genuinely important information remains unknown.

Sophisticated risk management techniques, long the private preserve of specialists, have been rammed into the mainstream. It is possible that the billions spent on IFRS 9 models might lead to some concrete improvements in the understanding of the risk in banks’ loan portfolios. This is the strong belief of most of the risk experts whose judgements we trust. In many cases, this will be the Hawthorne effect at work: being forced to gather information and generate loss expectations will lead inevitably to heightened awareness of risk and reduced chance of errors through ignorance. On the other hand, there will be cases where ECL models mislead management or obfuscate the risk assessment.

Third party advisors and consultants have been in great demand and have played a critical role in the delivery of IFRS 9. They are now similarly engaged in CECL work with GAAP reporters, in advance of the US GAAP go-live in approximately two years’ time. Helping banks build the information, systems, processes, methodologies and governance for ECL provisioning established itself as a significant business for consultants. They now tell us that “It’s time to look beyond IFRS 9” (to IFRS 15, as it happens, or to FRTB).

**Perfect foresight in stress tests**

As well as giving parameters for macroeconomic stress, industry-wide stress tests need to guide banks on how their views of the future will evolve within the stress. The answer, as illustrated by the BoE and EBA approach described above, has generally been to assume “perfect foresight” in the economic assumptions in the stress.

*Which is ludicrous. And dangerous.*

The assumption of “perfect foresight”, when used in a framework of forward-looking ECL provisioning, takes a starting point that is totally unprepared and then immediately front-loads effectively the entire losses of a credit downturn on day one of the hypothetical stress.

This is unrealistic and results in a provisions shock that is far greater than anything that would ever materialise in the real world. Real downturns are characterised by a gradual onset followed by a gradual realisation of the severity. A far better and reasonably realistic approach would have been to assume some kind of expectations “glide path” — say, making *expectations* for Yr2 equal to the average of Yr1 *actuals* and the Yr2’s assumed *outturn*.

In a word, good foresight is better than perfect foresight.

**How much more volatile are IFRS 9 / CECL provisions?**

The sensitivity and pro-cyclicality of the new provisioning regimes during downturns is little understood. A small amount of research, however, is beginning to become available. For example, Moody’s calculates that CECL loss allowances can be 50-60% more volatile than under the old, incurred loss approach.\(^\text{28}\)

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\(^{27}\) Banks – It’s time to look beyond IFRS 9, KPMG, 11 December 2017

\(^{28}\) What Do Half-a-Million Loans Say About the Impact of CECL on Loan Loss Allowance?, Moody’s Analytics, February 2017
Volatility of Loss Allowance Rates

<table>
<thead>
<tr>
<th>Period</th>
<th>Incurred Loss</th>
<th>CECL</th>
</tr>
</thead>
<tbody>
<tr>
<td>Q3 2003 – Q4 2015</td>
<td>0.55%</td>
<td>0.83%</td>
</tr>
<tr>
<td>Q1 2007 – Q4 2010</td>
<td>0.66%</td>
<td>1.04%</td>
</tr>
</tbody>
</table>

On the one hand, these estimated numbers are enlightening and help us to improve our understanding of the potential behaviour of the new accounting standards under stress. On the other hand, the aggregate numbers may mask a more extreme reality for certain loans, portfolios or institutions. For example, the loans in Moody’s database have a short average maturity (only 2.13 years) – a bank with longer term loans will experience a more volatile loss allowance than the Moody’s analysis indicates.

Q1 2018 Financial Results: One-Off Impact of IFRS 9

During the second half of 2017, some banks gave indications of the anticipated impact of the first time application of IFRS 9 on their financial statements and, more importantly, on their regulatory capital metrics.

The chart below shows the reported impact for a sample of 48 banks from around the world. The sample is not meant to be representative, but nonetheless it is interesting to observe the overall pattern.

- 4 of the 48 (8%) have an impact in excess of 100bp
- 6 of the 48 (13%) have an impact of between 50bp and 100bp
- The simple, unweighted average of the sample is 41bp
- The median of the sample is 25bp

These actuals are in line with the impact studies cited above. They are far lower than they would have been back in 2014, when the IFRS 9 standard was finalised. This is due to the generally better macroeconomic environment and the large amount of provisions that have been taken in the interim four years.
IFRS 9 Disclosure

Q1 reporting this year had a special flavour. One CEO of a major bank acknowledged that explanations of IFRS 9 had dominated his Q1 earnings call ("All right. Well, thank you for joining the IFRS 9 call [...] It sort of reminds me of the Rubik’s Cube when it first came out. Lots of questions, but all solvable").

The advent of ECL provisioning in IFRS-world was accompanied by a new dimension in disclosure. Banks have generally offered at least a few words of explanation of the moving parts, with some going so far as to produce an IFRS 9 Transition Report of thirty pages or so. Market participants, meanwhile, have been focused on the one-off impact of the new standard, which has generally proven anticlimactic and insufficient to tempt analysts into the deeper and more detailed disclosures.

At this stage, it’s hard to know what to do with the data.

- Does it matter that Barclays assumes 4.8% UK unemployment in its baseline scenario\(^{29}\) whereas RBS assumes 5.3%\(^{31}\)?

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\(^{29}\) CIBC Q1 2018 Earnings Call Transcript, Bloomberg, 22 February 2018

\(^{31}\)
What are investors supposed to do with the knowledge that Deutsche Bank treats overdrafts as having a 12 month lifetime “where such facilities are subject to individual review by Credit Risk Management” and 24 months where there is no such individual review?

Is it worth time to reflect upon Unicredit’s assumptions for annual GDP growth in the adverse scenario (1.5pp lower than the baseline), when we don’t know the probability weighting of such a scenario?

When will anyone give the market a feel for sensitivity of IFRS 9 provisioning – and hence regulatory CET1 solvency – to a shift in economic conditions?

It’s hard not to frown a little when one re-reads the ESRB’s comment on the need for clarity of information: “Adequate disclosures will be vital to ensure that markets receive the information required to adequately judge the performance of an entity and make informed investment decisions”. It’s not clear that the markets are focused or resourced adequately to receive and process these types of disclosures.

On the back of all this disclosure, it’s interesting to speak with investors, to find out what the end users of financial information are doing with that information. Anecdotal evidence suggests that some are reversing IFRS 9 provisions out of P&L metrics and basing valuation assessments on pre-provision profit. So much for the information value of the new standard.

Credit protection under IFRS 9

Banks are understandably keen to manage the impacts of IFRS 9 and CECL and are exploring market-based mechanisms to dampen provisions volatility.

Unfortunately, the IFRS 9 standard does not give much help in understanding how credit protection can offset ECL provisions. The only real guidance is in paragraph B5.5.55: “The estimate of expected cash flows shall reflect the cash flows expected from collateral and other credit enhancements that are part of the contractual terms and are not recognised separately by the entity”.

So, it seems – and this is not accounting advice, let’s be clear – that market-sourced credit protection doesn’t reduce the ECL provision. Protection creates a fair value asset that increases in value as the loan deteriorates (and decreases in value should the loan increase in creditworthiness). This is hardly an effective mitigant, because the ECL is not an economic metric whereas protection is. This is most evident at the point of transition from stage 1 to stage 2, whereupon there can be a step-change from one-year ECL to LECL but only a tiny shift from an economic or fair value perspective.

One type of protection – where a portfolio “first loss” tranche is retained and deducted from regulatory capital – does appear to provide immunity from IFRS 9 provisions volatility, although this is in regulatory capital rather than accounting equity. An increase in ECL or LECL provision reduces accounting equity but can be offset by a corresponding reduction in the regulatory deduction and so, net net, CET1 solvency is flat.

A recent Deloitte paper was welcome as it appeared to offer solutions, but the description is confusing (eg. “The credit derivative provides an asset to mitigate the expected losses of the protected segment thus reducing the P&L impact of the provisions […] a P&L gain will be recognised to the extent that the ECL on the reference assets will ultimately be reimbursed by the structure thereby providing a degree of P&L offset”) and we have failed to understand the proposed mechanics.

30 IFRS 9 Transition Note, Barclays, March 2018
31 IFRS 9 Transition Report, RBS, February 2018
32 IFRS 9 Transition Report, Deutsche Bank, April 2018
33 Report on Transition to ‘IFRS 9 Financial Instruments’ of UniCredit Group, 10 May 2018
34 Securitisation: reducing risk and accounting volatility: IFRS 9 and significant risk transfer, Deloitte, May 2018
So, for the time being at least, confusion reigns. Transaction experience will be required to generate precedents and this may be a bit hit-and-miss.

**Impact on business models**

Over the last year, there has been a huge increase in discussions on the business impact of ECL provisioning, as opposed to the delivery-focused methodological discussions that were the focus previously.

- For the first time, IFRS 9 has moved from the Risk/IT/Finance departments to front-line business units and strategy teams
- Armed with reliable data, business units are now able to see the rough impact of the new standard on their business activities
- Already, there is clear evidence that product redesign is taking place (pricing, term). Some banks are looking at IFRS-friendly structures such as revolving rather than term facilities.
- In the extreme, businesses that are characterised by high expected loss rates, long tenor or high migration risk – and hence highly susceptible to large stage 2 provisions – are under pressure. There may even have been some discreet exits already
- Yet, few banks are clear or decisive. The impact of IFRS 9 still feels rather hypothetical. The low one-off impact has dulled the impact, for the time being at least, until banks see the behaviour of IFRS 9 provisions under stress.
- Few banks have incorporated stressed IFRS 9 provisions into their capital allocation methodologies
- Credit Portfolio Management functions are only just beginning to think about concrete actions to mitigate the impact of IFRS 9
- Credit departments are beginning to look at ways of keeping loans out of Stage 2
- There is a tension as regards collateral: whilst it has become less important for “Basel IV” purposes, it is of increased relevance for IFRS 9 capital efficiency

**IFRS 9 impact on S&P capital metrics**

In February 2018, S&P published a rather disappointing report on how it was planning to adapt its methodologies to the new IFRS 9-based numbers. The upshot is that “changes in accounting rules, in themselves, should not lead to changes in issuer credit ratings”. Phew. Nevertheless, S&P does not appear to be planning to add back excessive IFRS 9 provisions to TAC, its measure of capital, so RAC ratios will drop and become more volatile. Instead, S&P indicated that any neutralisation is likely to occur via the risk score. This is likely to be awkward in practice.

S&P also noted that IFRS 9 will have damaging effects on the market, for example through a shift towards shorter-term products, complexities leading to market confusion and an increase in procyclicality. That said, S&P reportedly believes at this stage that “the risks of procyclicality may not be as significant as some market participants fear”.

Encouragingly, S&P also believes that “the Basel Committee will undoubtedly seek to revise its capital rules to address the move to expected credit loss models in accounting”. A pre-taste of Basel V? (see below).

In a subsequent paper addressing the potential impact of CECL in the US, S&P repeated its approach and its views on the financial impact of ECL provisioning.

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35 The Adoption Of IFRS 9 And Bank Ratings, S&P, 19 February 2018
36 How An Accounting Change For U.S. Banks Could Affect Reserves And Ratings, S&P, 1 June 2018
S&P’s synopsis of likely impact of CECL on US Banks

“Change in reserve methodology could alter banks’ behaviour and strategies”
“Could result in bank management teams opting to hold higher capital levels”
“CECL will also make comparative analysis more difficult among banks” though “enhanced required disclosures are intended to enable investors to better discern the rationale behind a bank’s loan reserve”
“Banks may also change the composition and duration of their loan portfolios”
“The amount of provisions for banks that have higher growth strategies will be larger than for banks that have more modest growth strategies”
“The positive benefits from DTAs are limited somewhat from a capital standpoint”
“Higher capital burn down—i.e., decline in capital ratios” under CCAR
“Lower capital payouts for banks or banks altering their loan portfolios to minimize the impact of CCAR”
“More variability in reserving policies”
“CECL could lead to some banks shifting their lending strategies, favouring shorter-duration loans over longer-term loans”
“Banks may add renewal options to contractual terms to shorten the duration of certain commercial loan products”
“CECL could disadvantage banks that are looking to grow significantly versus a lower-growth strategy”
CECL “may make banks more loath to lend as economic conditions worsen, in an attempt to ensure their capital stays above minimum required levels”

Although S&P’s lack of revision to its capital methodology is disappointing, it is very encouraging to read its very clear view on the likely impact of ECL provisioning on banks, their owners and their customers. It represents further confirmation of the negative, unintended consequences of IFRS 9 and CECL. And again, like the ESRB perspectives outlined above, it is sensational.

Basel V

Now there’s an idea.

We’ve been saying for some time that ECL provisioning is a bad development for the banking industry that brings unwarranted complexity, subjectivity and procyclical volatility of financial metrics. We’ve even gone so far as to say that ECL provisioning is a process mistake, the result of a misunderstanding of the G20’s actual request.

We also note that the IASB does not champion the final IFRS 9 standard as the right approach: it is the result of a compromise with the industry, following the rejection of a conceptually better proposal. “It was a consequence of operationalising previous proposals and efforts to balance the benefits of faithful representation with the costs of application”.

But we’ve been forced to admit that the industry shows no signs of shelving IFRS 9 and there is only a small chance that the post-implementation experiences of IFRS reporters will cause the FASB to put CECL on ice.

So the real target is to change banking regulation, to make Basel compatible with ECL provisioning. Doing this properly would constitute a genuine “Basel V”. Yes, the markets would still need to grapple with complex and misleading IFRS 9 numbers to assess performance. But if the solvency calculation could somehow adjust properly for ECL provisions, then solvency would be stronger and less volatile.

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37 IASB Staff Paper, Project Financial Instruments: Impairment, Comment Letter Summary, IASB Meeting, 22-26 July 2013
And, in an existential way, solvency is what really matters – it’s the *sine qua non* of a bank. Regulatory solvency drives the ability of a bank to grow the business and distribute capital. Accounting profit matters less than the generation of genuinely surplus solvency capital resources.

Basel V should remove or resolve the double count between lifetime ECL provisions and one-year unexpected loss (UL) capital resources. There are many different ways of doing this, for example:

A. Treat “excess provisions” (the difference between one-year ECL and lifetime ECL for Stage 2 loans) as CET1

B. Incorporate expected future margin as a positive asset, offsetting the impact of expected future credit losses

C. Reduce capital requirements by the amount of “excess provisions” (again, the difference between one-year ECL and lifetime ECL for Stage 2 loans) maybe with a floor at zero

D. Reduce minimum regulatory solvency ratios for banks with ECL provisioning (say, replacing the Basel 8% minimum capital ratio requirement to 4%)

All of these seem unpalatable at first sight! To get the right answer, there is a need to conduct a fundamental rethink. Sadly, there is no evidence that this process has started. The last time that there was good thinking on the nature of capital from Basel was some 17 years ago. It’s worth re-reading old papers to remind oneself of the interaction between expected loss, unexpected loss and income. The Basel capital construct needs to be rebuilt to take into account the drastically different meaning of the new, post-IFRS 9 accounting equity number.

**Mitigants and Solutions**

In previous notes, we have set out some of the actions that banks should be considering, in order to manage their financial situation post IFRS 9, ranging from product design and repricing to purposefully putting certain portfolios into fair value accounting.

There will be some situations where it might make sense to de-risk assets selectively and reduce the IFRS 9 lifetime loss provision for Stage 2 assets in an efficient manner. To this end, BNP Paribas’ Global Markets solutions teams have developed a set of potential solutions, based primarily on securitisation technology and swap contracts.

**Glass Half-Full? Next Steps for H2 2018**

The advent of expected loss provisioning in IFRS 9 and CECL is truly a voyage of discovery. The anticipated parallel run of IFRS 9 didn’t materialise and so the market is forced in 2018 to use “beta test” numbers in a real live “production environment”. In turn, banks, investors and the authorities in the US will have the luxury of looking at IFRS 9 experience to support their policy development vis-à-vis CECL.

On a constructive note, we expect this year’s stress tests to be highly informative and lead to a constructive and informed industry dialogue on how to deal with IFRS 9 and CECL. We also expect banks to continue to make their solvency more “IFRS 9 friendly” by steering their businesses in a different direction and/or using volatility-absorbing solutions on the capital or the risk side.

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“Much Ado About Nothing” or “Après Moi, Le Deluge”?

Clearly, we do not think that the ECL provisioning approach contained within IFRS 9 and CECL is “nothing”, even though the 2018 go-live of IFRS 9 was, as it happened, an anti-climax. So, we don’t think our efforts to raise awareness of the strategic implications were “much ado about nothing”.

But nor do we desire a negative outcome for the banking industry. There is no point in being able to say “we told you so!”. Yes, our sense at present is that industry apathy and political correctness lead to a situation where unnecessary risks are being created. Inactivity at current levels does indeed mean that we can imagine future problems, just as Madame de Pompadour did: “Après moi, le deluge”.

Instead, our preference is to play a role in spurring constructive debate, criticism and reform. The banking industry is too important and too valuable to leave these newly introduced latent risks unattended.

As ever, the BNP Paribas team is keen to deploy its resources to assist clients in these efforts. We will try to keep close to developments in IFRS 9, CECL and the regulatory capital discussions. We would welcome feedback on the contents of this note and are happy to answer questions and debate alternative views.

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### LIST OF ACRONYMS

<table>
<thead>
<tr>
<th>Acronym</th>
<th>Constituent Words</th>
</tr>
</thead>
<tbody>
<tr>
<td>ACS</td>
<td>Annual Cyclic Scenario</td>
</tr>
<tr>
<td>BoE</td>
<td>Bank of England</td>
</tr>
<tr>
<td>CECL</td>
<td>Current Expected Credit Loss (outlined in ASU 2016-13)</td>
</tr>
<tr>
<td>CET1</td>
<td>Common Equity Tier 1</td>
</tr>
<tr>
<td>EBA</td>
<td>European Banking Authority</td>
</tr>
<tr>
<td>ECB</td>
<td>European Central Bank</td>
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<tr>
<td>ECL</td>
<td>Expected Credit Loss</td>
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<tr>
<td>ESCB</td>
<td>European System of Central Banks</td>
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<tr>
<td>ESRB</td>
<td>European Systemic Risk Board</td>
</tr>
<tr>
<td>FPC</td>
<td>Financial Policy Committee (of the BoE)</td>
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<tr>
<td>FRTB</td>
<td>Fundamental Review of the Trading Book</td>
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<tr>
<td>IASB</td>
<td>International Accounting Standards Board</td>
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<tr>
<td>IRB</td>
<td>Internal Ratings-Based</td>
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<tr>
<td>LECL</td>
<td>Lifetime Expected Credit Loss</td>
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<tr>
<td>SSM</td>
<td>Single Supervisory Mechanism (part of ECB)</td>
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<tr>
<td>TRG</td>
<td>Transition Resource Group</td>
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</tbody>
</table>
## ANNEX A

**Assessment of IFRS 9 using European System of Central Banks’ Qualitative Assessment Framework**

<table>
<thead>
<tr>
<th>Objective</th>
<th>Assessment</th>
</tr>
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<tbody>
<tr>
<td>1 Reflect the economic substance of the operations.</td>
<td>Unlike IAS 39, IFRS 9 is on the whole based on a set of clear and understandable principles. The “relative credit risk assessment” underlying the stages in the IFRS 9 impairment model aims to reflect the economic substance of lending and loan losses, with the recognition of 12-month ECLs in stage 1 as a reasonable compromise between conceptual merit and operationality.</td>
</tr>
<tr>
<td>2 Reliable and relevant values</td>
<td>IFRS 9 aims to provide relevant information. Its main innovation, the new ECL model, responds to the G20’s request to strengthen accounting of loan loss provisions by incorporating a broader range of credit information. Whether this does result in more reliable information will largely depend on the quality of the implementation of the ECL model and the emergence of “best practices” regarding the various issues where the implementation is open to discretion.</td>
</tr>
<tr>
<td>3 Allocation and magnitude of risks</td>
<td>By opting for fair value measurement for all trading assets and derivatives, IFRS 9 aims to fully reflect the risks incurred. In terms of reflecting the credit risk of assets measured at amortised cost in a more comprehensive and timely manner, the ECL model constitutes an improvement over the incurred loss model of IAS 39.</td>
</tr>
<tr>
<td>4 Comparability across firms, essential for market discipline.</td>
<td>By definition, principles-based accounting frameworks involve a certain degree of judgement (“subjectivity”), which may impede the comparability of the resulting accounting information. That said, certain limitations to comparability need to be balanced against the relevance of the resulting information. The ultimate assessment of whether IFRS 9 will increase the comparability of financial statements will largely depend on how successful the relevant stakeholders are in ensuring a consistent implementation.</td>
</tr>
<tr>
<td>5 Clear and understandable</td>
<td>Overall, the ECL model in IFRS 9 is expected to increase the complexity of accounting, requiring highly sophisticated methods and advanced skills (e.g. to estimate forward-looking ECLs). Adequate disclosures will be vital to ensure that markets receive the information required to adequately judge the performance of an entity and make informed investment decisions.</td>
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<tr>
<td>6 Accurate portrayal of solvency</td>
<td>The ECL model of IFRS 9 has the potential to prevent the understatement of credit risk in good times and will tend to reflect the deterioration of credit risk in bad times in a timelier manner.</td>
</tr>
<tr>
<td>7 Alignment of accounting rules and sound risk management practices:</td>
<td>The ECL model of IFRS 9 better reflects credit risks that are inherent in asset portfolios before these risks actually materialise, especially when compared with the incurred loss model of IAS 39. However, the concept of lifetime ECL introduced by IFRS 9 may not be fully aligned with certain current risk management practices which use shorter horizons.</td>
</tr>
<tr>
<td>8 Promotion of a forward-looking recognition of risks</td>
<td>One of the key features of IFRS 9 is the introduction of a forward-looking ECL model. Hence, it can be supported that IFRS 9 meets this criterion better than its incurred loss predecessor, simultaneously responding to the G20’s request for a timelier recognition of credit risks.</td>
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<tr>
<td>9 Avoidance of negative and promotion of positive externalities</td>
<td>There is a vast body of literature—with mixed results reported—assessing the interaction with regulatory requirements, the potential effect on credit supply, and the presence or not of cyclical effects, mainly in times of acute stress. Recent studies in accounting research find that delayed expected loss recognition is detrimental to financial stability, while the ultimate cyclical effects of the ECL model of IFRS 9 depend on the extent to which tail events can be anticipated and incorporated into the model.</td>
</tr>
<tr>
<td>10 Discourage and prevent the manipulation of accounts (“creative” accounting)</td>
<td>By its very nature, a principles-based accounting framework involves a certain degree of judgement. The benefits of ECL models largely depend on how the models are applied in practice as well as on the quality of data input into the models. In this context, the extent to which this criterion will be met will largely depend on banking supervisors, market regulators and auditors, who are expected to play a prominent role in ensuring the sound and consistent application of IFRS 9 in the EU.</td>
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