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Comments on the Potential Procyclical Effect of IFRS 9 During the COVID-19 Crisis

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Abstract

Some predicted new accounting standard IFRS 9 could constrain lending, hit banking earnings and harm the economy during times of crisis. Now, amid the COVID-19 outbreak, will this prediction come true? Our analysis points to yes, under certain conditions.

Keywords: IFRS 9; International Financial Reporting Standards; CECL; Current Expected Credit Loss; new accounting standards; loan loss provisioning; COVID-19; coronavirus; crisis; procyclicality; CDS spreads; lending; banking

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The wake of the COVID-19 outbreak has raised the concern that IFRS 9 could have a procyclical effect that exarcerbates the economic damage of the pandemic. The new standard requires banks to build provisions based on *expected* losses. Anticipating a significant deterioration of credit conditions as a consequence of COVID-19, banks would be forced to increase provisions. This would result in lower earnings, lower capital ratios, and credit contraction precisely at the moment when lending is most needed.

The concern about the role of IFRS 9 on the current crisis has prompted some banks and even regulators, such as Federal Deposit Insurance Corp. (FDIC) Chairman Jelena McWilliams, to call to delay the US analog of IFRS 9 -the CECL (Current Expected Credit Loss) standard, which is being implemented for the first time in 2020.[1]

Recent research on IFRS 9 is consistent with the concern that, under certain circumstances, the new standard can increase procyclicality. Using simulation, Abad and Suarez (2018) show that the expected loss model imposed by IFRS 9 increases more suddenly the level of provisions than the incurred loss model used under the previous standard (IAS 39) when the economy switches from expansion to contraction. In turn, regulatory capital declines more severely at the beginning of the downturn. This could decrease procyclicality by inducing banks to take action in early stages of the downturn, while decreasing loss recognition at the worst moment of the crisis. However, Abad and Suarez (2018) also show that the difficulty to anticipate the arrival of a contraction exacerbates the cyclical effects of IFRS. The current pandemic is a case in point: no one anticipated the COVID-19 outbreak.

One limitation of this prior research on IFRS 9 is that the evidence is based on simulations, since the study was conducted before the implementation of the standard. In our recent paper entitled “Switching from Incurred to Expected Loan Loss Provisioning: Early Evidence”, we address this limitation by using the first actual data produced under the new rules. We obtain two relevant results that can shed light on the potential procyclical effects of IFRS 9 during the current crisis.

First, we show that the loan loss provisioning is more predictive of future firm risk under IFRS 9 than under IAS 39. Note that finding that IFRS 9 has an important informational effect supports the position of those who are reluctant to suspend the application of the standard. Our results suggest that, despite concerns about the accounting discretion involved in the IFRS 9 estimations and the inherent difficulty in estimating expected losses, the resulting accounting numbers are indeed informative about future risk. However, an alternative interpretation of our evidence is that, to the extent that the new standard is not inconsequential, it could also have procyclical effects.

Second, we find a decrease in the level of lending in the first year of implementation of IFRS 9. The decrease in credit is accompanied by an increase in the level of loan loss provisions. This result supports the claim that, during the COVID-19 crisis, IFRS 9 will have an adverse effect on credit by increasing bank provisions (i.e., banks could reduce credit to offset the reduction in the capital ratio caused by higher level of provisions).

[1] See, for example,

"Fed Said to Review Easing Bank Leverage, Accounting Rules - Bloomberg." StreetInsider.com. Accessed March 26, 2020. https://www.streetinsider.com/Fed/Fed+said+to+review+easing+bank+leverage%2C+accounting+rules+-+Bloomberg/16628068.html.

"McWilliams Urges FASB to Halt CECL Implementation." American Banker. Last modified March 19, 2020. https://www.americanbanker.com/news/mcwilliams-urges-fasb-to-halt-cecl-implementation.

Importantly, the previous results are significant only in countries where there was a significant increase in the spread of Credit Default Swaps (CDS) of Sovereign Bonds. That is, the countries experiencing more difficulties are the ones affected by the implementation of IFRS 9.

To corroborate the relevance of these results for the debate on how to deal with IFRS 9 during this crisis, we analyze the association between CDS spreads of sovereign bonds and the number of infections around the world. As shown in Table 1, an increase in the number of COVID-19 cases in a country drives up the CDS spread of the corresponding sovereign security. Thus, based on the results of our paper, it is possible that the deterioration of credit conditions as a result of the pandemic amplifies the effect of IFRS 9 on credit.

Table 1
Sovereign CDS spreads and coronavirus cases

Independent Variables:	**Dependent Variable:** ***5Y CDS*** **(1)**
COVID-19	0.24***
	(3.87)
COVID-19*ECB	-0.62**
	(-2.24)
Controls:	
ECB	-2.57
	(-0.69)
MSCIWorld	-0.72***
	(-3.17)
Country FE	Yes
Adj-R^2	0.266
N	420

Note: This table presents an analysis of the relationship between the number of newly confirmed COVID- 19 cases and Sovereign CDS spreads. The dependent variable is the daily change in the level of 5-year (5Y) CDS spread (in bp). COVID-19 is the number of newly confirmed COVID-19 cases on that day. ECB is an indicator variable which takes 1 for European countries after the ECB announced new QE program on 18 March 2020. COVID-19*ECB is an interaction term between COVID-19 and ECB. Daily return in MSCI AC World index (local currency) is included to control for global risk sentiment. The sample includes a panel of 420 observations, covering Top 20 countries in terms of the total number of confirmed COVID- 19 cases as of 18 March 2020 (China, Italy, Spain, France, South Korea, Germany, USA, Switzerland, UK, Netherlands, Austria, Belgium, Norway, Sweden, Denmark, Japan, Malaysia, Portugal, Canada and Czech Republic, Iran was excluded as CDS data were not available on daily basis). Daily data since 21 February, when lockdown of several cities in Lombardy, Italy was announced, through 20 March 2020 were used. Standard errors are clustered at Country level and *t*-statistics are in parentheses. *, ** and *** denote significance at the 10%, 5%, and 1% level (two-tail) respectively. Intercepts are omitted. COVID-19 data are taken from WHO and Sovereign CDS data are taken from Capital IQ. MSCI AC World Index (local currency) data is taken from Datastream.

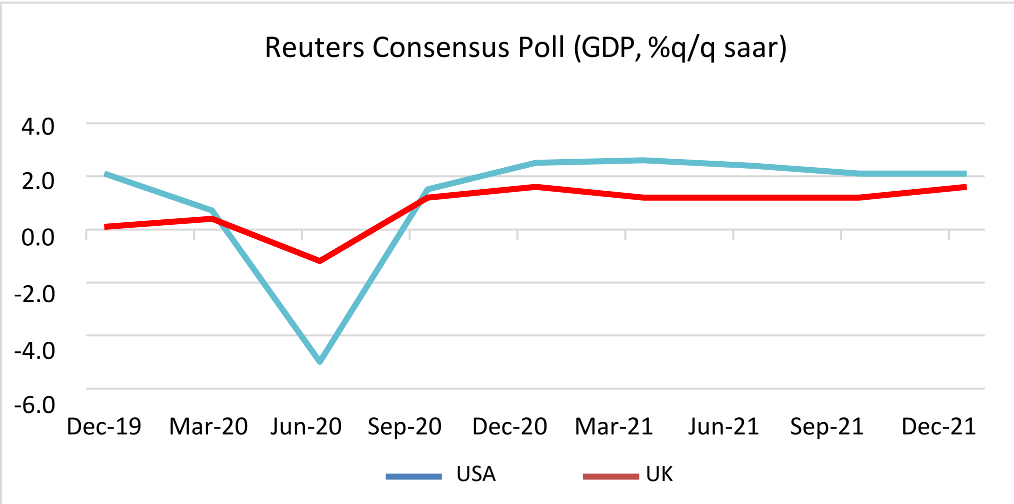
Source: Prepared by the authors.

However, it is also plausible that the potential procyclical effect of IFRS 9 during the COVID-19 crisis ends up not being first order. That would be the case if the effect of the pandemic is temporary and relatively short-lived and mitigated by government intervention. Note that the macroeconomic scenarios used to estimate credit losses are relatively long term (5 years or more). Moreover, a large part of loan contracts are written with a maturity of several years.

Finally, both European and local governments/institutions are committed to help borrowers navigate the crisis.

To explore the validity of these arguments, we first collect data on current expectations on the development of the crisis. **Figure 1** presents recent consensus GDP forecasts for US and UK. As shown in the table, the most common expectation is that the economy will recover from the present downturn in the fall. While there is substantial uncertainty about the severity and duration of the present crisis, the forecasts in **Figure 1** suggest that it is not farfetched to expect that the effect of COVID-19 is temporary and relatively short-lived.

Figure 1
GDP Forecasts Over the Next Months



Source: Reuters Eikon, US forecast is as of 19 March 2020 and UK forecast is as of 16 March 2020, accessed 22 March 2020.

Finally, we examine the credibility of the assumption that fiscal and monetary policy will greatly mitigate the effect of COVID-19 on the economy. **Figures 2** and **3** plot the recent time-series of CDS spreads of sovereign bonds of China and Italy. The figures show evidence that government intervention can curve the increase in CDS spreads. In particular, **Figure 2** shows that CDS spreads of Chinese bonds flattened after the announcement of the lockdown, and **Figure 3** shows that Italian CDS spreads decreased at the announcement of the ECB's stabilization package.

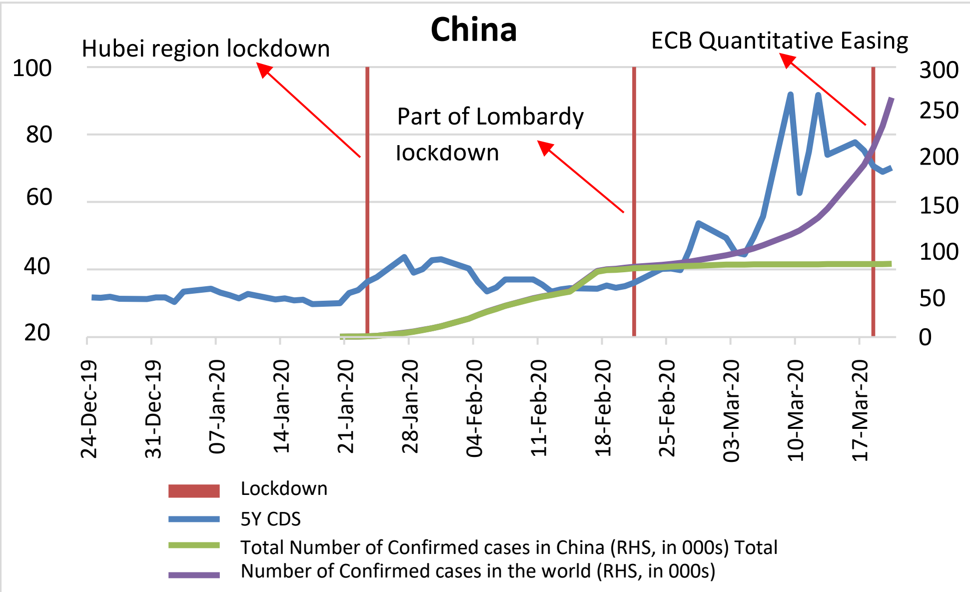
One final issue potentially affecting the procyclicality of IFRS 9 is that, under the current uncertainty the assumptions of banks' models to estimate expected credit losses could be heterogeneous, to the detriment of the reliability and comparability of loan loss provisioning. While there is probably no perfect fix for these problems, these issues are relatively second-order if the national authorities define macroeconomic scenarios to be used by all banks in the country. In fact the ECB is committed to provide central macroeconomic scenarios.[2]

[2] European Central Bank. "FAQs on ECB Supervisory Measures in Reaction to the Coronavirus." European Central Bank - Banking Supervision. Accessed March 26, 2020. https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200320_FAQs~a4ac38e3ef.en.html.

In sum, based on the data we have analyzed, we conclude that the procyclical effect of IFRS 9 in this crisis will not be first-order if the economic turmoil caused by the COVID-19 is relatively short-lived. However, if the duration of the pandemic is longer than expected, the IFRS 9 could end up generating procyclicality.

Figure 2

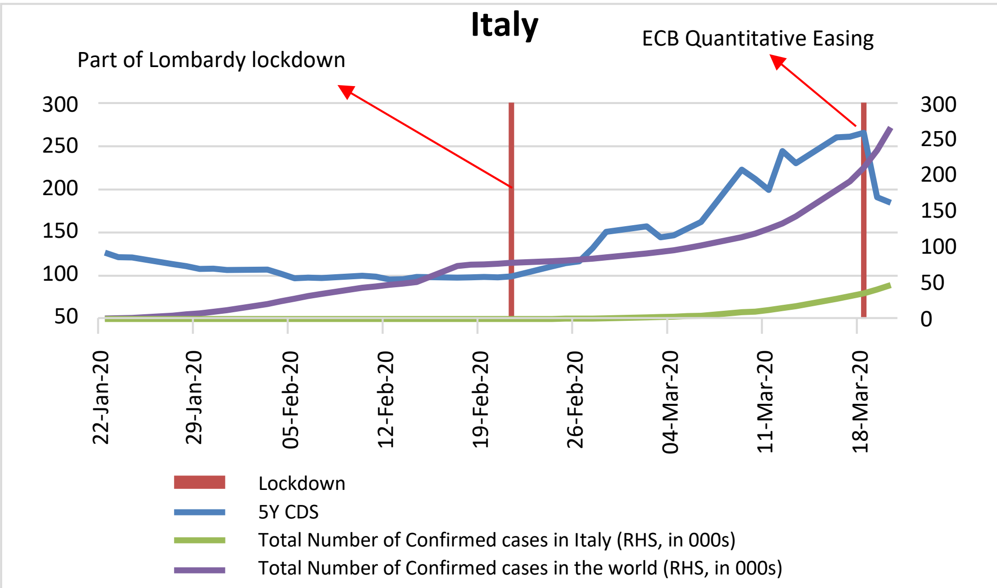
China Sovereign CDS and Government Intervention



Source: Capital IQ, accessed 22 March 2020.

Figure 3

Italy Sovereign CDS and government intervention



Source: Capital IQ.

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