Dear colleagues, ladies and gentlemen, good morning.

1. Introduction

It is a pleasure for me, and an honor, to have the opportunity to address you on the occasion of this ISDA Accounting Meeting, here in Lisbon, on the subject “Accounting for Derivatives and Financial Instruments”, with special focus on the IFRS 9 – Financial Instruments.

I would like to begin by thanking the organizers for giving me the opportunity to take part in this event. The implementation of IFRS 9 in January 1st, 2018 is consensually considered as one of the major challenges to the financial sector, supervisors and analysts, due to the significance of the changes related to the accounting themes of classification and measurement of financial instruments.

From a regulatory and supervisory perspective, I hold as utmost importance a proper and sound adoption of IFRS 9 assumptions by financial institutions and its capacities to keep up with the financial innovation, due to the inherent risk of complex operations, as well as the necessity of a clear, complete and consistent disclosure of the IFRS 9 accounting and operational impacts on the financial statements of financial institutions.

2. Background of IFRS 9

After the 2009 G20’s concerns on the current incurred-loss impairment model approach – which was found to be “too little, too late” in terms of credit-loss recognition - the International Accounting Standards Board (IASB\(^1\)) and the Financial Accounting Standards Board (FASB\(^2\)) jointly started the development of an approach that incorporates “forward-looking” reasonable and supportable information on the impairment assessment.

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\(^1\) Responsible for IFRS framework  
\(^2\) Responsible for US-GAAP framework
Despite IASB and FASB have not agreed an agreement on a final joint approach to address this concern, they both established standards that incorporate an expected credit-loss (ECL) model, which deserves to be praised.

In this new accounting paradigm for financial instruments envisaged in the IFRS 9, there is a clear conceptual simplification achieved with the new classification model of financial assets and also a qualitative shift from an incurred loss model to an expected credit loss model.

3. Prudential and financial stability concerns (with focus on the impairment theme)

As you know, accounting policies and standards are of the upmost importance for supervision and financial stability frameworks, as they rely heavily on the accounting figures reported by financial institutions. Therefore, changes in the accounting landscape of financial institutions should be carefully discussed and assessed, in order to anticipate how potential accounting impacts should be “prudentially” addressed.

Once IFRS 9 will significantly impact, not only but also, on the impairment assessment of financial assets - which is considered to be one of the issues with most weight in the P&L performance and leading indicator of the assets quality (Loans & receivables and securities) of financial institutions - it should be taken as a micro and macro prudential priority from the point of view of the financial stability.

• IFRS 9 Challenges

In the new accounting paradigm for financial instruments envisaged in the IFRS 9 there is a clear conceptual simplification achieved with the new classification model of financial assets and also a qualitative shift from an incurred loss model to an expected credit loss model.

I believe that there are obviously many issues requiring significant judgment on practical implementation of the new impairment requirements. Without entering in too much detail, I would like to highlight some of the main issues here:

✓ First, the definition of default is one of the most important keys for impairment modelling. Thus, it should deserve particular attention, including the explanation of potential deviations between the “accounting definition” and the “prudential definition”. While IFRS 9 implies a conceptual convergence between the accounting and regulatory approaches to credit risk, there are also important technical differences, which I will discuss in a while.
Second, assessing whether there is a significant increase in credit risk is crucial to “jump” from the so-called stage 1 (“performing”) to stage 2 (“underperforming”).

Finally, an innovative feature of the IFRS 9 is the consideration of forecasts of future economic conditions in the measurement of expected credit losses. In my view, the definition and update of macroeconomic scenarios pose significant challenges to the impairment estimation process. Some examples relate to the number of scenarios; the definition of a baseline scenario, alternative scenarios, and representative scenarios; the sensitivity and asymmetries; the coherence between parameters; the granularity of the adjustments; the definition of the time horizon; or the extrapolation of projections and refreshment frequency.

I understand and agree that uncertainty is inherent to any impairment model, but to achieve a proper level of reliability it is important that institutions put in place resilient internal governance based on procedures to control subjectivity around assumptions and other sources of estimation uncertainty. Examples of such procedures should be related with the implementation of appropriate and regular back-testing or independent validation (internal or external) of the impairment models as well as an extensive and high quality disclosure in order to allow stakeholders to understand the modeling assumptions behind the impairment allowances.

I am fully convinced that the consistent application of criteria over time is fundamental to ensure that impairment charges are adequately registered.

Other challenge is the investment that the large majority of the banks has been doing in risk models, IT, infrastructures, data collection and human resources. It is foreseeable that this challenge will affect more “standardized approach (SA)” banks giving their more limited experience with expected credit loss models.

- **IFRS 9 – transitional arrangements for prudential purposes**

Under normal circumstances, the shift from the “incurred loss model” (envisaged in IAS 39) to the “expected loss model” (envisaged in IFRS 9) should lead to an increase of accounting impairments and consequently to a reduction on capital ratios. It is also worth noting that prudential impacts tend to be higher for those portfolios subject to the SA when compared to those banks applying the “internal ratings based approach (IRB)”.

To avoid unintended effects, various fora (for instance, the Basel Committee, the European Commission and the European Banking Authority) are considering the adoption of transitional arrangements to guarantee that credit institutions have enough time to absorb the prudential impacts and therefore avoid a potential “capital shock”.

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On October 2016, the Basel Committee on Banking Supervision issued one consultative document and one discussion paper\(^3\) regarding the regulatory treatment of regulatory provisions. On March 2017 a set of rules was published for transitional arrangements covering amongst others (i) the option for a “static” or “dynamic” approach, and (ii) a preference for a amortization of the IFRS 9 impact on impairment within a period no longer than five years.

The European Commission proposed in November 2016 the introduction in the Capital Requirements Regulations (CRR) of a transitional regime to accommodate the prudential impacts from the expected credit loss model (IFRS 9). This proposal is under discussion at the meetings of the Working Party on Financial Services of the European Council.

Given that in less than one year from now financial institutions will be valuing their credit exposures using IFRS 9, it is extremely important to reach an agreement on the transitional impact that should allow to absorb gradually the impact of the IFRS 9 in the regulatory framework (CRR/CRD).

- **EBA 1st Impact Assessment on the impact of IFRS 9**

On April 2016, the EBA published a survey developed to assess the readiness of the European banking sector regarding the implementation of IFRS 9. The results reported, based on a representative sample of the European banks (own estimates as of 31 December 2015), showed that banks were at an early stage of preparation, using several assumptions and simplifications in the responses to the impact study that do not necessarily represent their final IFRS 9 methodology.

On the quantitative side, the results of the survey indicate that the estimated increase of provisions compared to the current levels of provisions under IAS 39 reached 18% on average, and up to 30% for the 75\(^{th}\) percentile; in terms of the estimation of the impact on solvency ratios, CET1 and Total capital ratios are estimated to decrease, on average, by 59 bps and 45 bps, respectively, and up to 75 bps for the 75\(^{th}\) percentile.

This survey was very much beneficial for planning the following steps of the EBA work on IFRS 9, which materialized with the launch, on November 2016, of a 2\(^{nd}\) EBA impact assessment on IFRS 9 with the view to obtain revised quantitative impact results as well as the current status of implementation. Moreover, the EBA is also engaged on communication with banks and auditors on the implementation issues observed in the first exercise and is strongly encouraging banks to strength their efforts towards the implementation of IFRS9.

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\(^3\) “Regulatory treatment of accounting provisions – interim approach and transitional arrangements” (available at https://www.bis.org/bcbs/publ/d386.htm) and “Regulatory treatment of accounting provisions” [a long-term approach] (available at https://www.bis.org/bcbs/publ/d385.htm).
• The importance of a level playing field inside and outside the European Union

The safeguard of a level playing field in the application of a single ECL model, both inside and outside of the European Union has been jeopardized due to the multiplicity of current national accounting policies. In what regards the comparison between an EU-GAAP (IFRS endorsed by the EU) and US-GAAP, as mentioned before, the IASB and the FASB did not reach an agreement on a joint approach to the G20 concern on the “incurred loss” model. The major divergence consisted in the scope of application of the ECL model, that in the views of the FASB should be required to entities to recognize current expected credit losses for all assets, and not only those for which there has been a significant increase in credit risk since initial recognition.

Moreover, the FASB ECL standard (Financial Instruments—Credit Losses) will only enter into force on January 1st, 2021, three years after the date of application of IFRS 9 (January 1st, 2018).

However, also within the EU the accounting framework is not fully harmonized. While for consolidated basis purposes, financial institutions in the European Union present its financial statements in accordance with the IFRS, in several EU countries this is not the case in individual basis, as they still use a national accounting framework.

• Cyclicality of IFRS 9

The transition from an incurred loss model to an expected credit loss model will tend to mitigate the pro-cyclicality present in the current accounting standard. This is so because the paradigm changes from a model that requires the occurrence of “triggering” events, supported by observable evidence combined with expert judgment (incurred loss model), to a model that does not require those trigger events and grounds on a forward-looking approach which emphasizes the probability of future credit losses even if no such triggering events have yet occurred (expected credit loss model).

We should bear in mind that from a financial stability perspective the main concern shall be whether loan loss accounting amplifies the upward and downward swings of the business cycle. In this regards the current accounting standard proved to be highly pro-cyclical.

In any case, the cyclicality embedded in the new IFRS9 – and, in particular, the differences between expected losses for regulatory and accounting purposes - is a matter that needs further assessment and discussion.

The pillar underlying IFRS 9 is the estimation of expected losses, which rely on the estimation of two building blocks: probabilities of default (PDs) and loss given default (LGD). There is ample evidence that our assessment of these two risk metrics varies through the cycle. Even if we adopt a “through the cycle” perspective, such as that typically used in the internal ratings model implemented for regulatory purposes, our
assessment of PDs may sometimes be subject to cyclical fluctuations depending on where in the cycle we are. Even though regulators and supervisors ask institutions to use the longest time span of data available in their internal ratings models, it is relatively rare for an institution to have good granular data on credit risk covering an entire business cycle (and incredibly rare to cover a full credit cycle, which is often much longer).

Critically, this “through the cycle” perspective is not what is foreseen in IFRS 9, which aims at a “point-in-time” approach. While through-the-cycle default probabilities reflect cycle-neutral economic conditions (and can include an adjustment for prudence), point-in-time default probabilities reflect current economic conditions (and do not necessarily contain an adjustment for prudence). Regulation also prescribes the concept of “downturn” loss given default, which is not the same as that foreseen in IFRS 9, which should be more sensitive to prevailing economic conditions.

These apparently small conceptual details may lead to practical differences between expected losses computed for regulatory and accounting purposes, with the latter showing more volatility through the cycle. On the one hand, asking institutions to consider the credit risk underlying their exposures also for accounting purposes will increase the synergies between regulatory and accounting information and, more importantly, it will help investors and other stakeholders to better assess the current and prospective value of a firm. On the other hand, the differences in the technical aspects underlying the two approaches are in many dimensions irreconcilable, thus leading to potential discrepancies in the two perspectives.

To be sure, one of the most relevant differences between the accounting and regulatory approaches will very likely be the cyclicality of expected losses, which is expected to be larger in the accounting framework. As such, at the peak of cycle accounting information may give a more optimistic view about the risk exposures than the prudential information, while the opposite may occur during downturns. How relevant these different perspectives will be for the different stakeholders (e.g. shareholders, auditors, supervisors) in shaping the policy debate in different stages of the cycle is surely an open question.

The cyclical impact of the IFRS 9 will be felt on different stages of the life of the loan. At origination, the calculation of expected losses will vary with prevailing macroeconomic and financial conditions. As I mentioned just a while ago, this may be due to shortcomings in the available data, as well as to the point-in-time approach. Later in the lifetime of the loan, if there is evidence of a deterioration in credit quality, loans will move from the so-called stage 1 to stage 2 (if they are underperforming) or to stage 3 (if they are non-performing). At the individual loan level, this will also strengthen the links with the business cycle, as the computation of probabilities of default when the loan reaches stage 2 or 3 is affected by the considerations above. More importantly, when loans go from stage 1 to stages 2 or 3, cliff-effects will arise because default probabilities have to be computed with a lifetime horizon, instead of the 12-month period used in stage 1. In fact, existing estimates suggest that most of the impact of the
implementation of IFRS 9 should come from the recognition of losses in stage 2, rather than from the recognition of losses in stage 1.

The cyclicality embedded in banks’ balance sheets through the implementation of IFRS 9 can of course have implications on the amount of credit granted to the real economy, as well as on the price and maturities at which credit is granted. The available evidence suggests that banks will likely grant less credit during downturns, when the recognition of expected losses at origination is expected to be larger. Loan interest rates might also increase, as institutions pass on their provisioning costs to customers. Finally, banks are expected to grant loans at shorter maturities, to avoid expensive moves of loans to stage 2 or 3 in case of future economic shocks. Firms with more cyclical activities may be specially affected. All these effects will imply that the cyclicality associated with IFRS 9 goes well beyond the balance sheet of banks and may affect various dimensions of bank-based economies.

Nonetheless, by forcing banks to have an early recognition of potential losses, the incentives to engage in evergreening strategies become subdued. This may eventually shorten the length of recessions and create conditions for faster and stronger economic recoveries. For that purpose it is necessary that investment in models with sound forecasting capacity takes place such as to be possible to anticipate downturns and crisis well in advance.

To conclude here, let me say that it took us sometime to understand some of the procyclical implications embedded in Basel II, many of which associated with the use of internal rating models. Basel III took some important steps to address this, notably with the design of tools such as the countercyclical capital buffer. It is therefore of the upmost importance to assess the embedded pro-cyclicality in the implementation of the new IFRS 9 standards.

4. Other prudential concerns

IFRS 9 also covers other critical areas on the accounting of Financial Instruments. The establishment of simpler, but new categories of classification of financial instruments, the need to define a business model for every instrument, or perform the Solely Payment of Principal and Interest (SPPI) tests, are other examples of the magnitude of changes that have to be implemented, not only as of the transition date, but also imply that firms have to go back to the origination of the current exposures and assess the underlying credit risk at date and walkthrough to the present time. For this purpose, I consider it is essential to have a proper documentation of both historic data and assumptions defined by the competent decision-makers.

In what concerns the main changes in the hedge accounting one can identify as the most relevant ones (i) the reduction of volatility in results, since the time value of the options can be accounted for in OCI; (ii) the alignment of hedge accounting with the risk management policies; and (iii) the changes in the effectiveness testing.
5. Conclusion

To conclude, I would like to highlight that given the tight deadline for entry into force of the IFRS 9, as well as all the challenges underlying the adoption of this new accounting standard by financial institutions, it is essential that more and frequent communication between all of the stakeholders takes place in a timely manner in order to assure a proper and sound implementation of IFRS 9.

I would also like to wish you all the best for the remaining of this inspiring and well-apropos subject-matter discussion and indeed for the future. I am confident that we all will keep up the excellent work surrounding the challenges and complexity of the accounting for derivatives and financial instruments with enthusiasm and indisputable expertise.

Thank you very much.