The effectiveness of IFRS 9 transitional provisions in limiting the potential impact of COVID-19 on banks

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Abstract

The purpose of this paper is to assess the effectiveness of the transitional provisions for the impact of International Financial Reporting Standard 9 (IFRS 9) as a supervisory tool to strengthen a bank's capital base. The new IFRS 9 provisions are a significant banking supervisory measure of the so-called Capital Requirements Regulation (CRR) Quick Fix to mitigate possible adverse effects of the COVID-19 pandemic on banks. With the discharge rules, the supervisor aims to strengthen the banks' regulatory capital in order to ensure the supply of credit to households and companies at all times. Based on the published disclosure reports of 107 significant European banks at the reporting dates end 2019 and June 2020, our study analysed how many banks already apply the transition rules, whether there are geographical focusses and to what extent banks use the new CRR Quick Fix adjustments. To the best of our knowledge, this paper is the first empirical analysis of the extent to which European banks use the original IFRS 9 transitional arrangements and COVID-19 extension and what effects its use has on their common equity Tier 1 (CET1) capital. The results are of interest to regulators, bank managers and analysts alike, as they fundamentally demonstrate the effectiveness of this particular regulatory tool.

Keywords Banking regulation · Capital requirements regulation (CRR) · CET1 capital · Standardised approach to credit risk (CSA) · CRR Quick Fix · Internal rating-based approach (IRBA)

JEL Classification G21 · G28 · G32 · G38

Introduction—The CRR Quick Fix

The ongoing COVID-19 pandemic poses enormous challenges for people and companies alike. In addition to the humanitarian effects—such as contact restrictions and severe illness—the economic consequences, in particular, are still unpredictable and partly unmanageable. The economic crisis affects both the real economy and the financial world. Banks expect that the pandemic will lead to a deterioration in customers' creditworthiness and, somewhat deferred, to a

possible massive increase in loan defaults. Both politicians and banking regulators have reacted very quickly to this threat and have taken measures to mitigate the crisis' effects.

The Basel Committee on Banking Supervision (BCBS), the European Commission (EU), the European Banking Authority (EBA), the European Central Bank (ECB) as well as various national supervisors—such as the German Federal Financial Supervisory Authority (BaFin)—have taken several measures to prevent a banking crisis. The supervisory authorities are relaxing specific requirements in order to strengthen the banks' regulatory capital. Banks need capital to absorb or buffer unexpected losses that occur during the normal course of business. For the current topic, a clear distinction must be made between the most common accounting and regulatory approaches to defining capital.

The various definitions of a bank's 'equity' each emphasise different aspects of the desired information content. 'Equity capital' corresponds to the book value of a bank and, in simplified terms, is the sum of capital raised by a bank's owners and the profits retained from operations

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over its entire life. Market capitalisation ('market cap') refers to the market value of the balance sheet figure 'equity capital'. Shareholders' equity is the bank's somewhat narrower book value that the owners can claim as belonging to them in a hypothetical liquidation of the institution. Adding the capital held by other shareholders in subsidiaries that are majority-owned by the bank (minority interests) to the shareholders' equity gives the 'total equity capital' which together with the total liabilities yields the balance sheet total of a bank. If one subtracts the goodwill and other intangibles from the shareholders' equity, we get 'tangible (shareholders') equity'. Tangible equity as a measure of the 'core capital base' comprises retained earnings and funds raised from the owners [1].

From a regulatory perspective, a bank's 'own funds' consists of 'common equity Tier 1 (CET1)', 'additional Tier 1 (AT1)' and 'Tier 2 (T2) capital'. CET1 capital is based on balance sheet data and somewhat similar to tangible equity, as it strips out less reliable forms of capital. It consists of the sum of common shares or equivalent for non-joint stock companies and stock surplus, retained earnings, other comprehensive income, and qualifying minority interest. However, a bank must consider several regulatory adjustments and deduction positions to calculate the CET1 capital. Thus, the CET1 capital is not equal to other accounting capital. AT1 capital comprises subordinated debt instruments, which can be wiped out or converted into equity under certain conditions. All instruments meeting the criteria for AT1 must contain no incentive for the issuer to redeem them. T2 capital consists of capital reserves of lower or less reliable quality than T1 capital. For this reason, T2 capital instruments—like paid-up capital instruments, subordinated loans and undisclosed reserves—are considered less effective in absorbing a bank's losses [2].

The minimum regulatory capital requirement for core risks limits, in a more or less restrictive form is the bank's business volume, as all its risk positions must be secured with the available own funds. The regulatory capital ratio for core risk—credit, market price, and operational risks—is the most crucial regulatory instrument to assess a bank's robustness and the 'heart' of regulatory measures. The regulatory minimum ratio for these risks stipulates that the percentage share of a bank's eligible own funds in the total risk-weighted positions must be at least eight per cent. In other words, the volume of the positions may not exceed 12.5 times (reciprocal of eight per cent) the bank's own funds. Thus, lower regulatory capital goes hand in hand, *ceteris paribus*, with a smaller volume of business. Thus, a shortage of regulatory capital at the banks would relatively quickly lead to a bottleneck in the supply of credit. Banks would generally have to reduce the volume of credit in order to maintain the minimum own funds ratio. A possible credit

crunch would further affect the already burdened non-banks and possibly drive them into bankruptcy, even though they have sufficient creditworthiness.

The EU's so-called CRR Quick Fix—more precisely Regulation (EU) 2020/873—stands out among all supervisory measures to facilitate lending in response to COVID-19 [3]. The term 'quick fix' refers to adjustments at short notice to Regulations (EU) No. 575/2013 (CRR I) and (EU) 2019/876 (CRR II) [4, 5]. The CRR Quick Fix was published in the Official Journal of the EU on 26 June 2020 and entered into force the following day. Thus, Banks were already able to apply relief rules of the CRR Quick Fix by the reporting deadline of 30 June 2020. The Capital Requirements Regulation (CRR) is the prominent banking supervision regulation for European banks, particularly concerning capital adequacy and liquidity requirements [5, 6].

The Quick Fix legislation postpones existing regulations that burden the banks' own funds, especially CET1 capital, into the future. For example, supervision allows institutions to temporarily exclude specific exposures to central banks from the computation of an institution's total exposure (Article 500b CRR) and apply the revised calculation of the leverage ratio exposure value of regular way purchases and sales awaiting settlement in order to ensure that the treatment properly reflects the inherent leverage associated with those trades (Article 500d CRR).

At the same time, the CRR Quick Fix already allows the application of particular regulations that should only be introduced at a later date. Immediately applicable to banks are the more favourable regulatory treatment of loans to small and medium-sized enterprises (SMEs), infrastructure exposures and loans to pensioners and employees secured by the borrower's pension or salary (Articles 123, 501 and 501a CRR). From the 1 of January 2020 to the 31 of December 2022, a temporary prudential filter for unrealised gains and losses measured at fair value through other comprehensive income is also introduced. The filter refers to exposures to central governments, to regional governments or local authorities (Article 115(2) CRR) and to public sector entities (Article 116(4) CRR), excluding those financial assets that are credit-impaired.

In particular, this paper analyses the CRR Quick Fix's redefinition of the International Reporting Standard 9 (IFRS 9) transitional arrangements of the International Accounting Standards Board (IASB) to mitigate the potential negative impact of likely increases in provisions for expected credit losses due to the economic impact of the COVID-19 crisis on banks' regulatory capital and lending capacity. IFRS 9 was published on 24 July 2014 and replaced International Accounting Standard 39 (IAS 39). It contains rules for the recognition and valuation, derecognition and hedge accounting of financial instruments. Banks were required to apply the standard for fiscal years beginning

on or after 1 January 2018. In the paper's further course, the transitional provisions to IFRS 9 are presented first, followed by the CRR Quick Fix's adjustments. One focus lies in calculating the transition effect with its static, dynamic, and new COVID-19 component.

An empirical study on the topic 'application of IFRS 9 transition rules in Europe' completes the paper. Based on the published disclosure reports of 107 significant European banks at the reporting dates ending 2019 and June 2020, our study analyses how many banks already apply the transition rules, whether there are geographical focuses and if banks use the CRR Quick Fix adjustments. We will also estimate the impact of the original IFRS 9 transitional arrangements and COVID-19 extension on the banks' CET1 capital.

Our paper's structure is as follows: In Sect. 2, we summarise the complex transitional provisions of IFRS 9 in a few simple formulas. The new adjustments to the IFRS rules due to the Covid-19 pandemic are discussed in Sect. 3. Section 4 presents the empirical analysis results on the application of the transitional provisions at European banks and effectiveness as a supervisory instrument. Section 5 concludes the paper with a summary and possible challenges in practice.

IFRS 9—Transitional arrangements

The CRR adjustments that came into effect on 28 December 2017 regarding the transitional provisions to mitigate the impact of the introduction of IFRS 9 on regulatory capital (Art. 473a CRR) will be extensively adjusted to the benefit of banks as part of the CRR Quick Fix. Thus, the EU is reacting in a forward-looking manner to a potentially significant decline in CET1 capital caused by the increased IFRS 9 rules when calculating the allowance for losses on financial instruments for fiscal years beginning on or after 1 January 2018. Any increases in the allowance for losses on loans and advances following IFRS 9 will be excluded entirely from CET1 in 2020 and 2021 and phased in gradually over three years until 2025.

The IFRS 9 standard implements the specifications of the G20 finance ministers for the forward-looking recognition of loan loss provisions by introducing an expected credit loss (ECL) model, which can result in significantly higher loan loss provisions compared with IAS 39 at the time of initial application or a later date if the overall macroeconomic situation deteriorates. Even if banks do not yet apply the existing transitional provisions for IFRS 9 risk provisioning, they are allowed to reverse this decision because of the COVID-19 pandemic but need the competent authority's approval.

The core principle of the transition rules is that if a bank suffers a decrease in its CET1 capital due to IFRS 9, it can eliminate this decline. The bank can do so by adding back increases in ECL provisions for non-credit-impaired assets

to CET1 capital. The transitional period should have a maximum duration of five years and should start in 2018. The portion of ECL provisions that can be added back in CET1 capital should decrease over time down to zero to ensure the full CET1 impact of IFRS 9 on the day immediately after the end of the transitional period.

The transitional effect's exact calculation is divided into two components: a 'static' and a 'dynamic' component. The static component (SC) calculates differences between IFRS 9 provisions relating to the date of initial application of IFRS 9 (t_1) and IAS 39 provisions calculated at the day before the date of initial application of IFRS 9 (t_0). In other words, the static component relates to the 'day-one impact' of IFRS 9 on CET1. The dynamic component captures the 'post-day-one impact' of IFRS 9 on CET1 capital.

Banks using the standardised approach to credit risk (CSA) for the calculation of risk-weighted assets (RWA) use Eq. (1) for the computation of the SC :

$$SC_{CSA} = \max(P_{t1} - P_{t0}, 0), \quad (1)$$

where SC_{CSA} denotes the static component of the capital correction for credit risk positions that fall under the scope of the CSA. P_{t1} and P_{t0} represent the amount of credit loss provisions for CSA positions described above on the first date of IFRS 9 application and the day immediately before the first application of IFRS 9 (IAS 39 provisions), respectively.

Banks using the internal ratings-based approach (IRBA) calculate the static component considering the so-called expected loss (EL) comparison effect that additionally influences the CET1 capital. If the sum of all credit risk provisions that fall under the treatment of the IRBA minus the sum of all accounting risk provisions for credit risk positions that fall within the scope of the IRBA is negative, then the result must be deducted from CET1. If the difference is positive, the amount can be added in Tier 2 capital. This calculation is performed separately for defaulted and non-defaulted positions. Equation (2) shows the static component calculation:

$$SC_{IRBA} = \max\{\max(P_{t1} - EL_{t1}, 0) - \max(P_{t0} - EL_{t0}, 0), 0\}, \quad (2)$$

where SC_{IRBA} denotes the static component of the capital correction for credit risk position that falls into the scope of the IRBA. P_{t1} and P_{t0} depict the sum of credit loss provisions for IRBA positions described above on the first date of IFRS 9 application and the day before the first application of IFRS 9 (IAS 39 provisions). The variable EL_{t1} stands for the sum of expected loss amounts for IRBA positions described above on the IFRS 9 application's first date. Analogously, EL_{t0} denotes the sum of expected loss amounts for IRBA positions described above on the day before the first application of IFRS 9 (IAS 39 provisions). The SC amount

calculated in this way is ‘static’, as it does not change from one reference date to another and stays the same over the transition period of five years.

The ‘dynamic’ component (DC) calculates the differences between IFRS 9 provisions on non-impaired exposures between the current reporting date (t_x) and the date of initial application of IFRS 9 (t_i). It is dynamic, as it changes depending on the provision amount calculated on the current reporting date. For CSA positions, i.e. for positions that fall into the scope of the credit risk standard approach, Eq. (3) applies:

$$DC_{CSA} = \max(P_{tx} - P_{t1}, 0), \quad (3)$$

where DC_{CSA} gives the dynamic component of the capital correction for credit risk positions that fall into the CSA scope. P_{t1} and P_{tx} depict the amount of credit loss provisions described above for CSA positions on the first date of IFRS 9 application and the reporting date, respectively.

Similar to the SC for IRBA positions, for the calculation of DC , the EL comparison effect must be considered, and therefore Eq. (4) needs to be used:

$$DC_{IRBA} = \max\{\max(P_{tx} - EL_{tx}, 0) - \max(P_{t1} - EL_{t1}, 0), 0\}, \quad (4)$$

where DC_{IRBA} denotes the dynamic component of the capital correction for credit risk position that falls into the scope of the IRBA. P_{t1} and P_{tx} depict the sum of credit loss provisions for IRBA positions described above on the first date of IFRS 9 application and the reporting date, respectively. The variable EL_{t1} stands for the sum of expected loss amounts for IRBA positions described above on the first date of IFRS 9 application. Analogously, EL_{tx} denotes the sum of expected loss amounts for IRBA positions described above on the reporting date.

Furthermore, all effects due to differences between tax accounting and IFRS 9 credit loss provisions (T) should be eliminated. These effects are mainly deferred tax assets that must be deducted from CET1 capital according to CRR Article 36. The deduction amount for deferred tax assets follows a complex calculation including several netting possibilities and thresholds. This will be not further considered in this article due to simplification.

The overall correction will be phased out over five years using a scaling factor. The following scaling factors (S)—95 per cent in 2018, 85 per cent in 2019, 70 per cent in 2020, 50 per cent in 2021 and 25 per cent in 2022—are used. The overall correction amount, i.e. the capital amount that is added to CET1 capital, is therefore calculated using Eq. (5):

$$RCC_{ix} = (SC_{CSA} + DC_{CSA} - T_{CSA} + SC_{IRBA} + DC_{IRBA} - T_{IRBA})S_{ix}, \quad (5)$$

where the new variables denote the following: RCC_{ix} —Regulatory CET1 correction according to IFRS 9 transition rules at the reporting date t_x , T_{CSA}/T_{IRBA} —impact on CET1 capital due to differences in tax and IFRS 9 accounting for CSA/IRBA positions, and S_{ix} —applicable scaling factor for reporting date t_x .

Banks had to inform the relevant supervisor of their initial decision regarding applying transitional rules by 1 February 2018. However, an institution may reverse the initial decision to apply or not apply the transitional arrangements once during the transitional period, subject to prior permission of the supervisor. The second subparagraph of Article 473a (9) CRR sets out an option for institutions that decided to apply only the static component but not use the dynamic component. In that case, the supervisor shall also be informed by the institution by 1 February 2018. Similarly, whether to apply or not the transitional arrangements, the decision to use the dynamic component may be reversed once during the transitional period, subject to prior permission of the supervisor. Let us now turn our attention to the new regulations designed to help banks during the Covid-19 pandemic.

IFRS 9—COVID-19 adjustments

The application of IFRS 9 during the economic downturn caused by the COVID-19 pandemic could lead to a sudden significant increase in expected credit loss provisions as many clients face financial problems and risk provisions have to be increased. To reduce the potential negative impact of this increase of risk provisions on the regulatory capital, the Basel Committee (BCBS) agreed on 3 April 2020, to allow more flexibility in implementing the transitional arrangements that phase-in the impact of IFRS 9.

The European Commission followed the BCBS recommendation and published the CRR Quick Fix regulations to mitigate any negative impact from the COVID-19 pandemic. Among other changes, particularly the adjustments and extension of IFRS 9 transitional rules, is an essential issue for banks. So, the CRR Quick Fix introduces a new transition period, namely 2020 to 2024.

In addition to the static and dynamic component, a COVID-19 component (CC) was introduced. The CC calculates differences between IFRS 9 provisions on non-impaired exposures between reporting date (t_x) and 1 January 2020, which reflect the start of the pandemic (t_{20}). The CC is similar to DC , as it changes depending on the amount of provisions calculated on the current reporting date. The CC will be phased out, identical to the initial CET1 correction over five years.

Institutions are allowed according to Article 473a (6a) CRR to completely add back to their CET1 capital any increase in new ECL provisions that they recognise in 2020

(compared to 70 per cent under the previous rules) and 2021 (compared to 50 per cent under the previous rules) for their financial assets that are not credit-impaired. Those changes would bring additional relief from the impact of the COVID-19 pandemic on institutions' possible increase in provisioning needs under IFRS 9 while maintaining the transitional arrangements for the expected credit loss amounts established before the COVID-19 pandemic. From 2022 onwards, the phase-out starts with 75 per cent, 50 per cent in 2023, 25 per cent in 2024; beginning 2025 there will be no more correction. The phase-out of the original *SC* and *DC* is not changed; therefore, the aforementioned *S* scaling factor is different for *SC* and *DC* compared to *CC*.

$$RCC_{tx,CC} = \{SC_{CSA} + DC_{CSA,adj} - T_{CSA} + SC_{IRBA} + DC_{IRBA,adj} - T_{IRBA}\}S_{tx} + \{CC_{CSA} + CC_{IRBA} - T_{CSA,20} - T_{IRBA,20}\}S_{CC,tx}, \quad (10)$$

The calculation of the COVID-19 component follows the same approach as for *DC* and is calculated using Eq. (6):

$$CC_{CSA} = \max(P_{tx} - P_{t20}, 0), \quad (6)$$

where CC_{CSA} depicts the COVID-19 component of the capital correction for credit risk positions that fall into the scope of the CSA. P_{t20} and P_{tx} represent the amount of credit loss provisions described above for CSA positions on 1 January 2020 and on the reporting date, respectively.

As with the *SC* and *DC* for IRBA positions, for the calculation of *CC* the *EL* comparison effect must be considered and therefore Eq. (7) used:

$$CC_{IRBA} = \max\{\max(P_{tx} - EL_{tx}, 0) - \max(P_{t20} - EL_{t20}, 0), 0\}, \quad (7)$$

where CC_{IRBA} depicts the COVID-19 component of the capital correction for credit risk positions that fall into the scope of the IRBA. P_{t20} and P_{tx} reflect the amount of credit loss provisions for IRBA positions described above on 1 January 2020 and the reporting date, respectively. EL_{t20} and EL_{tx} stand for the sum of expected loss amounts for IRBA positions described above on 1 January 2020 and the reporting date.

Since the Covid-19 components in Eqs. (6) and (7) already capture the respective differences in the period from t_{20} to tx , the differences for the dynamic components for the CSA—Eq. (3)—and for the IRBA—Eq. (4)—must not be determined for the period t_1 to tx but the shorter t_1 to t_{20} . Equations (8) and (9) give us the adjusted values:

$$DC_{CSA,adj} = \max(P_{t20} - P_{t1}, 0) \quad (8)$$

and

$$DC_{IRBA,adj} = \max\{\max(P_{t20} - EL_{t20}, 0) - \max(P_{t1} - EL_{t1}, 0), 0\} \quad (9)$$

where $DC_{IRBA,adj}$ depicts the dynamic component of the capital correction for credit risk positions that fall into the scope of the IRBA. P_{t20} and P_{t1} represent the sum of credit loss provisions for IRBA positions described above on 1 January 2020 and the first date of IFRS 9 application, respectively. EL_{t20} and EL_{t1} stand for the sum of expected loss amounts for IRBA positions on 1 January 2020 and the first date of IFRS 9 application.

The additional capital to be added back to CET1—the overall correction amount—including *SC*, *DC* and *CC*, is calculated following Eq. (10):

where the variables not yet mentioned denote the following: $RCC_{tx,CC}$ —Regulatory CET1 correction according to IFRS 9 transition rules including the Covid-19 components at the reporting date t_x , $DC_{CSA,adj}/DC_{IRBA,adj}$ —Adjusted dynamic component of the capital correction for credit risk position that falls into the scope of the CSA/IRBA, $T_{CSA,20}/T_{IRBA,20}$ —Impact on capital due to differences in tax and IFRS 9 accounting for CSA/IRBA positions from 1 January 2020 on, and $S_{CC,tx}$ —Applicable scaling factors for CC_{CSA}/CC_{IRBA} at the reporting date t_x . Equation (10) uses different scaling factors for the *SC* and *DC* on one side and the *CC* on the other. A higher scaling factor increases the magnitude of the effect of the transitional arrangements. Figure 1 illustrates the calculation of the regulatory CET1 correction according to IFRS 9 transition rules for banks using the CSA.

Navigating the transition—Before and during COVID-19

The extension of the transitional IFRS 9 rules are one of the most critical measures of the EU commission to protect banks from the COVID-19 crisis and assure that banks do not reduce the amount of provision of credit for the real economy, as this would even increase the economic impact of the ongoing pandemic. After the detailed description of how the correction of CET1 due to IFRS 9 transition rules is calculated, we want to provide an overview of how successful the IFRS 9 provision rules are.

We have analysed the impact of the original IFRS 9 transition rules and the COVID 19 extensions on the level of CET1 capital. For this analysis, we used publicly available information, especially the Pillar 3 disclosure reports of

Fig. 1 Overview IFRS 9 transition rules for the standardised approach to credit risk (CSA) as of 30 June 2020

31 December 2019 and 30 June 2020 of the ECB supervised banking groups. As of 1 September 2020, 114 significant entities are directly supervised by the ECB, so-called significant institutions (SIs) [8]. From these SIs, the published disclosure reports of 107 for the end of 2019 and June 2020 were analysed. Some fifty-four per cent of the banks in the sample do not apply the transitional IFRS 9 rules, neither before nor after COVID-19. Around six per cent of banks

use the SC only, and 24.3 per cent both SC and DC. An increasing number of banks—15 per cent in total—started using CC. Figure 2 summarises the use of IFRS transition rules, including the CRR Quick Fix extensions.

In general, Banks do not explain in detail the reasoning for using the IFRS 9 transitional rules in their reports. Still, from our analysis, in many cases the answer is straightforward, as it can be seen that transition to IFRS 9 provisioning

Fig. 2 Use of IFRS 9 transition rules including the CRR Quick Fix extensions at 107 ECB supervised banking groups at the end of June 2020

has a significant negative impact on CET1 ratio in the first year. Transitional arrangements smooth the adverse effects over time. The early adopters were banks with a substantial amount of non-performing exposures, as the expected credit loss (ECL) model led to a significant increase in these exposures' provisions.

Banks that do not apply the transitional provisions of IFRS 9 also do not disclose reasons for their actions. Nevertheless, there are two apparent reasons. First, the operational effort to implement the calculation for IFRS 9 is not negligible, and in most cases, a manual adjustment has to be performed. Second, the IFRS 9 transitional rules enhance only the regulatory CET1 capital for the purpose of the CET1 ratio calculation. No 'real' capital, like accounting capital, is generated.

Regarding the first reason, we take Germany as an example, where none of the banks in our scope chooses to

implement IFRS 9 transitional rules initially. This situation can possibly be attributed to the fact that German banks have very small non-performing loans (NPL) ratios compared to other ECB-supervised banks. Hence, the effort to calculate the adjustment is relatively high compared to the CET1 gain that can be achieved. Regarding the latter case, we have to acknowledge that banks have to disclose to market participants their CET1 ratios both with and without applying the IFRS 9 transition rules. Thus, there might be no incentive to perform double calculations if market participants judge the banks' solvency by looking at the fully-loaded CET1 ratio.

By examining the banks' geographical distribution, banks predominantly in countries with high NPL ratios applied the transitional rules for IFRS 9 when they were initially introduced (see Fig. 3). Countries with high NPL ratios are, for example, Spain, Italy, Greece, Cyprus and Portugal. This result corresponds to the official NPE ratio published for

Fig. 3 The 34 out of 107 banks, segmented by country, applying the transition rules of IFRS 9 per country as of 31 December 2019

Fig. 4 Non-performing exposure ratio in Europe as of December 2019 (extract of countries) Source: [9, p.15]

these countries, which is above the European average of 2.4 per cent for the end of 2019 (see Fig. 4). Considering only the impact of the original IFRS 9 transitional rules at the ECB supervised banks, our analysis shows that CET1 capital of €17.9bn has been ‘created’ as of 31 December 2019.

With the introduction of CRR Quick Fix, an increasing number of banks reversed their decision not to use transitional IFRS 9 rules due to the COVID-19 pandemic. As of 30 June 2020, 49 banks make use of the transitional rules. At the end of 2019, only 34 banks had them applied (see Fig. 3). Based on our analysis, this means that the number of ECB supervised banks grew by 44 per cent (see Fig. 5). This time, banks from almost all Eurozone countries use the transition rules. By looking to the disclosure reports of June 2020, these banks stated that they overturned their initial decision not to phase out IFRS 9 following ECB’s recommendation and catering for COVID-19 impact.

The impact of the IFRS 9 transitional rules on CET1 capital is still not very high. However, the positive effects have increased proportionally to the increase in risk provisioning during the COVID-19 crisis. Based on the publicly available Pillar 3 reports as of June 2020, the rise in CET1 capital is only 3.2 per cent. Nevertheless, by introducing the CRR Quick Fix and the prior IFRS 9 transitional rules, the EU

commission unlocked up to €20.7bn CET1 capital, supporting the lending to the real economy (see Fig. 6).

The IFRS 9 transition rules of the CRR Quick Fix are considered the most crucial measure in banking regulation to mitigate the impact of the COVID-19 crisis. Nonetheless, looking at the figures mentioned above could lead to the impression that this measure is not very effective, given that many banks are not using these rules and the impact on banks that are using them is not very big. The small effect is because in many eurozone countries, debt moratoria and other support measures for the real economy ebbed the increase in credit defaults and loan loss provisions. These measures will probably expire at the end of the 1st quarter of 2021. It is expected that the provisions under IFRS 9 will rise significantly in Q3 and Q4 of 2020 and early 2021.

Challenges in practice—Uncharted territory

Several requirements introduced under the Regulation (EU) 2019/876 (CRR II) advantageous for banks are already applicable as of July 2020 through the CRR Quick Fix—much earlier than initially planned. The date of application of other

Fig. 5 The 49 out of 107 banks providing information on the IFRS transition rules as of 30 June 2020 (segmented by country)

Fig. 6 Core capital evolution with transitional arrangement impact (from Q1/2020 including the CRR Quick Fix)

relieving supervisory regulations under the CRR II has also been brought forward. These include the revised support factor for small and medium-sized enterprises (SMEs), the element to support infrastructure financing, relief for the deduction of intangible assets (software) and preferential treatment for loans secured by the borrower's pension or salary. Loans guaranteed by the public sector are also given preferential treatment when calculating the non-performing loans backstop.

Altogether, both the original IFRS 9 transition rules and the extension due to COVID-19 are a powerful instrument for avoiding a potential decrease in banks' lending to the real economy and an acceleration of the economic downturn. Based on the above-mentioned €20.7bn in released CET1 capital and assuming a general minimum CET1 ratio of 4.5 per cent plus 2.5 per cent capital conservation buffer, the potential of additional loans would be up to €295.7bn (assuming a standard risk weight of 100 per cent for private and corporate loans).

While the impact of the IFRS 9 transition rules on CET1 capital is not yet huge, this will likely change quickly. Therefore, many banks still do not use the transition rule to avoid implementation and calculation effort. This situation will definitely change in 2021, as most European countries face a second or even third wave of infections, leading to even higher negative growth rates of the economy. It is expected that the number of defaults, risk provisions and NPLs increases proportionally and that almost all banks will use the IFRS 9 transition rules to enhance their regulatory CET1 capital. Thus, the few but already available Pillar 3 disclosure reports of the ECB-supervised banking groups as of 31 December 2020 support our expectation that more and more banks will use the IFRS 9 transition rules to unleash existing CET1 capital for their operations.

From the regulators' perspective, the freed-up CET1 capital achieves the goal of allowing banks to possibly even increase their lending to the real economy in difficult economic times. Banks can only lend to the real economy—regardless of their book equity—if sufficient CET1 capital is available. By the IFRS 9 transition rules, no 'new' CET1 capital is generated, and no additional equity capital to buffer an increase of credit risk is available in the banking industry. The CET1 capital is a regulatory definition and the CET1 ratio one of the essential instruments for regulators and supervisors. The transitional rules free up existing CET1 capital, which should buffer IFRS 9 risks for other risk positions' capital backing. The released CET1 capital then increases the regulatory CET1 ratio, but not the bank's actual robustness or resilience.

However, investors could limit the basic effectiveness of the transitional rules if they ignore the practices and consider the CET1 ratio of a bank in their investment decisions without considering the IFRS 9 transition rule. The same

applies to rating agencies. Rating agencies use their definition of capital when assessing the credit quality of banks. It is highly probable that rating agencies will neglect the IFRS 9 transition rules of the CRR Quick Fix and that banks' ratings will deteriorate.

The management bodies of banks heavily dependent on the capital markets will consider both the potential reaction of investors and rating agencies in their management decisions. This means that despite the 'regulatory' increase of CET1 capital due to the CRR Quick Fix banks will reduce the number of loans to the real economy to avoid additional credit losses, increasing the economic crisis. We cannot estimate whether the CRR Quick Fix measures will be sufficient to counteract the adverse effects of the COVID-19 pandemic. Only time will tell.

Concluding the above-discussed impact of the IFRS 9 transition rules, we can say that the rules effectively increase the possibility of banks granting loans to the real economy during and after the COVID-19 crisis. But the effectiveness of the IFRS 9 transition rules is dampened by the fact that banks have to fulfil regulatory ratios as well as the expectation of investors and other financial markets participants. It is fully transparent to investors that the increase in CET1 capital is due to a regulatory correction but not by adding 'actual' equity capital, making the banks more resilient. Notwithstanding, with the expected high increase in risk provisions in 2021, the IFRS 9 transition rules become more important, especially for the many banks within the EU not driven by the capital markets. Therefore, we can state that the IFRS transition rules effectively promote lending during and after the COVID-19 crisis.

Declarations

Conflict of interest On behalf of all authors, the corresponding author states that there is no conflict of interest.

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