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From:	Presidency
To:	Delegations
Subject:	Possible changes to Article 473a CRR * Phase-in of regulatory impact of the introduction of IFRS 9

Delegations will find attached Presidency non-paper for the 16 March 2017 meeting.

16 March 2017
Working Party Financial Services (RRM)

Possible changes to Article 473a CRR Phase-in of regulatory impact of the introduction of IFRS 9

1. Introduction

Following the discussions at the last Council Working Group on 16 February 2017 and taking into account the written responses from the delegations to the specific questions on the transitional regime for IFRS 9 as set out in Article 473a of the CRR, the Presidency proposes a revised version of Article 473a that includes different options for further discussion.

The proposed draft aims to address issues that have been raised during the previous discussions, namely:

- who should decide on the application of the transitional arrangements;
- whether a dynamic or a static approach should be used for determining the amount of accounting provisions that should be added back;
- the length of the transitional period and portion of accounting provisions that should be added back in each year of that period;
- the total amount of accounting provisions that could be added back when institutions use the IRB approach;
- the adjustments needed to prevent double-counting; and
- the disclosure requirements.

The proposed draft also takes into account the forthcoming Basel rules text on an interim approach for the regulatory treatment of accounting provisions (publication expected towards end March) and the EBA opinion on transitional arrangements published on 6 March.

2. Who decides on the application of the transitional period? (Article 473a(1) of the CRR)

The first policy option is about who should decide on the application of the transitional period.

<u>Option 1a -</u> the choice is left to the individual institutions (COM proposal):

1. Until [31 December 2022][1] institutions that prepare their accounts in conformity with the international accounting standards adopted in

[1] Please note that the date is in square brackets because it depends on the chosen length of the transitional period. The 31 December 2022 date assumes a 5-year transitional period.

accordance with the procedure laid down in Article 6(2) of Regulation (EC) No 1606/2002 ***may,*** *by way of derogation from Article 50, add to their Common Equity Tier 1 capital the amount calculated in accordance with paragraphs 2 and 3 of this Article multiplied by the applicable factor laid down in paragraph 4 of this Article.*

Option 1b – the choice is left to competent authorities:

1. Until [31 December 2022] ***competent authorities may allow*** *institutions that prepare their accounts in conformity with the international accounting standards adopted in accordance with the procedure laid down in Article 6(2) of Regulation (EC) No 1606/2002, by way of derogation from Article 50, to add to their Common Equity Tier 1 capital the amount calculated in accordance with paragraphs 2 and 3 of this Article multiplied by the applicable factor laid down in paragraph 4 of this Article.*

Option 1c – the transitional period is made mandatory for all institutions, with the implicit permission to each institution to apply a more conservative treatment (i.e. no transitional period) in accordance with Article 3 of the CRR[2]:

1. Until [31 December 2022] institutions that prepare their accounts in conformity with the international accounting standards adopted in accordance with the procedure laid down in Article 6(2) of Regulation (EC) No 1606/2002 ***shall,*** *by way of derogation from Article 50, add to their Common Equity Tier 1 capital the amount calculated in accordance with paragraphs 2 and 3 of this Article multiplied by the applicable factor laid down in paragraph 4 of this Article.*

Question 1 Do Member States agree with the Commission's proposal? If not, which of the other two options would Member States prefer?
Question 2 For those Member States that prefer Option 1c, should a Recital be inserted to clarify the possibility to be more conservative through the application of Article 3 CRR?

3. Static vs dynamic approach (473a(2) of the CRR)

3.1 Static approach

For the static approach the starting point for the transitional amount would be the IFRS 9 total expected credit loss (ECL) provisions as at 1 January 2018 reduced by the total cumulative amount of impairment losses under IAS 39 as at 31 December 2017, subject to a floor of zero.

2. Institutions shall calculate the amount referred to in paragraph 1 as the greater of the amounts in points (a) and point (b):

(a) zero;

[2] According to Article 3 of the CRR, the CRR shall not prevent institutions from holding own funds and their components in excess of, or applying measures that are stricter than those required by the CRR.

(b) the after-tax amount calculated in accordance with point (i) reduced by the amount calculated in accordance with point (ii):

(i) the sum of the twelve month expected credit losses determined in accordance with paragraph 5.5.5 of Commission Regulation (EU) No 2016/2067[3] *and the amount of the loss allowance for lifetime expected losses determined in accordance with paragraph 5.5.3 of Commission Regulation (EU) No 2016/2067 as at 1 January 2018;*

(ii) the total amount of impairment losses on loans and receivables, held to maturity investments and available for sale assets determined in accordance with, respectively, paragraphs 63, 67 and 68 of IAS 39 of Commission Regulation (EC) No 1126/2008[4] *as at 31 December 2017.*

The amount in point (i) is the total amount of ECL provisions determined under IFRS 9, while the amount in point (ii) is the total amount of impairment losses determined under IAS 39.

<u>3.2 Dynamic approach</u>

For the dynamic approach the starting point for the transitional amount would be the sum of IFRS 9 'stage 1' 12-month ECL and the 'stage 2' lifetime ECL[5]. This is reflected in point (b)(i) of paragraph 2 of the text below. The adding back of the IAS 39 impairment losses that surpass the amount of IFRS 'stage 3' ECL, in the discussions labelled as the incurred-but-not-reported (IBNR) losses, is prevented. The amount of IBNR is calculated as a static amount to be deducted from the sum of IFRS 'stage 1' and 'stage 2' provisions during the full transitional period. The calculation of the amount of IBNR to be subtracted is laid down in point (b)(ii) of paragraph 2 of the text below. The difference between the two amounts is floored at zero.

2. Institutions shall calculate the amount referred to in paragraph 1 as the greater of the amounts in points (a) and point (b):

(a) zero;

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3 Commission Regulation (EU) No2016/2067 of 22 November 2016 amending Commission Regulation (EC) No 1126/2008 adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council as regards International Financial Reporting Standard 9 (OJ L 323, 29.11.2016, p. 1).

4 Commission Regulation (EC) No 1126/2008 of 3 November 2008 adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council (OJ L 320, 29.11.2008, p. 1).

5 A technical amendment to the Commission's proposal is made to differentiate accurately between 'stage 2' lifetime ECLs and 'stage 3' lifetime ECLs. The difference between 'stage 2' and 'stage 3' in IFRS 9 is based on accounting for interest revenue. 'Stage 3' is where the effective interest rate is no longer calculated on the basis of the gross carrying amount. By adding "financial assets that are <u>not</u> credit impaired" only 'stage 2' lifetime ECLs are captured. 'Credit impaired financial assets' is a term defined in Appendix I of IFRS 9 which is an integral part of the standard.

(b) the after-tax amount calculated in accordance with point (i) reduced by the amount calculated in accordance with point (ii):

(i) the sum of the twelve-month expected credit losses determined in accordance with paragraph 5.5.5 of Commission Regulation (EU) No 2016/2067 and the amount of the loss allowance for lifetime expected losses determined in accordance with paragraph 5.5.3 of that Regulation for financial assets that are not credit impaired.

(ii) the total amount of impairment losses on loans and receivables, held to maturity investments and available for sale assets determined in accordance with paragraphs 63, 67 and 68 of IAS 39 of Commission Regulation (EC) No 1126/2008 as at 31 December 2017, reduced by the total amount of the loss allowance for lifetime expected losses of credit impaired financial assets determined in accordance with paragraph 5.5.3 of that Regulation (EU) No 2016/2067 as at 1 January 2018.

Question 3 Taking into account the proposed modifications, do Member States prefer the dynamic approach or the static approach?
Question 4 Are any further modifications required to Member States' preferred approach?

4. Adjustment for institutions using the IRB approach (Article 473a(3) of the CRR)

For both the dynamic and the static approach only the accounting surplus above IRB EL amounts should be eligible for adding back to CET1 capital as otherwise EL amounts required to be deducted from CET1 (in accordance with Article 36(1)(d) of the CRR) under the IRB approach (set out in Chapter 3 of Title II of Part Three) would be added back to CET1 capital as well. Paragraph 3 lays down the adjustment to the total transitional amount determined under paragraph 2 for financial assets that are exposures subject to the IRB approach for credit losses. The total expected loss amount determined in accordance with Article 158(5), (6) and (8) of the CRR for non-defaulted assets[6] shall be deducted from the amount determined in paragraph 2.

3. For financial assets that are exposures subject to risk weighting in accordance with Chapter 3 of Title II of Part Three, institutions shall reduce the amount of expected credit losses for non-defaulted assets calculated in accordance with point (b)(i) of paragraph 2 by the expected loss amounts calculated in accordance with Article 158 (5), (6) and (10). Where the reduction would result in a negative amount it shall be calculated as zero.

Question 5 Do Member States agree to reduce, the total transitional amount that can be added back, by the IRB EL amounts laid down in paragraph 3 so as to ensure that only the surplus of accounting provisions compared to the IRB EL amounts can be added back?

[6] This modification is made so as to ensure that the surplus calculation applies only to assets included in IFRS 9 'stage 1' and 'stage 2' (non-defaulted / non-credit impaired) and not to defaulted / credit impaired assets in 'stage 3' or to off-balance sheet items.

5. The length of the transitional period and the portion of accounting provisions to be added back (Article 473a(4) of the CRR)

This policy option is about the length of the transitional period and the portion of accounting provisions that can be added back in each year during the transition period. The forthcoming Basel text foresees a maximum length of the transitional period of five years and a straight-line decrease in the portion of the amount to be added back. Three possible options are presented below.

Option 2a - full neutralisation in year 1 and a 5-year transitional period (Commission proposal):

> *4. Institutions shall apply the following factors to calculate the amount referred to in paragraph 1:*
>
> *(a)* ***1*** *in the period from 1 January 2018 to 31 December 2018;*
>
> *(b)* ***0,8*** *in the period from 1 January 2019 to 31 December 2019;*
>
> *(c)* ***0,6*** *in the period from 1 January 2020 to 31 December 2020;*
>
> *(d)* ***0,4*** *in the period from 1 January 2021to 31 December 2021;*
>
> *(e)* ***0,2*** *in the period from 1 January 2022 to 31 December 2022.*

Option 2b: no full neutralisation in the first year and a 5-year transitional period:

> *4. Institutions shall apply the following factors to calculate the amount referred to in paragraph 1:*
>
> *(a)* ***5/6*** *in the period from 1 January 2018 to 31 December 2018;*
>
> *(b)* ***4/6*** *in the period from 1 January 2019 to 31 December 2019;*
>
> *(c)* ***3/6*** *in the period from 1 January 2020 to 31 December 2020;*
>
> *(d)* ***2/6*** *in the period from 1 January 2021to 31 December 2021;*
>
> *(e)* ***1/6*** *in the period from 1 January 2022 to 31 December 2022.*

Option 2c: no full neutralization in the first year and a 4-year transition period:

> *4. Institutions shall apply the following factors to calculate the amount referred to in paragraph 1:*
>
> *(a)* ***0,8*** *in the period from 1 January 2018 to 31 December 2018;*
>
> *(b)* ***0,6*** *in the period from 1 January 2019 to 31 December 2019;*
>
> *(c)* ***0,4*** *in the period from 1 January 2020 to 31 December 2020;*
>
> *(d)* ***0,2*** *in the period from 1 January 2021to 31 December 2021.*

Option 2d: no full neutralisation in the first year and a 3-year transitional period:

> *4. Institutions shall apply the following factors to calculate the amount referred to in paragraph 1:*
>
> *(a) **0,75** in the period from 1 January 2018 to 31 December 2018;*
>
> *(b) **0,5** in the period from 1 January 2019 to 31 December 2019;*
>
> *(c) **0,25** in the period from 1 January 2020 to 31 December 2020.*

Question 6 Do Member States agree with the Commission proposal? If not, which of the alternative options would they prefer?

6. Adjustments to prevent double counting (Article 473a(5) of the CRR)

Because some accounting provisions are added back to CET1 capital, adjustments should be made to prevent that the added-back provisions are counted twice in the calculation of own funds and risk-weighted assets.

The draft text of paragraph 5 lists the items that should be adjusted, where applicable. These items are deferred tax assets (DTAs)[7], exposure values determined in accordance with Article 111(1) of the CRR (relevant for institutions using the standardised approach (SA) for credit risk)[8], the difference between EL calculated under the IRB approach and the accounting provisions for those losses[9]. In order to avoid drafting overly complicated rules on how the various adjustments should be made, a general catch all clause is proposed as the last subparagraph of paragraph 5.

> *5. Where an institution adds an amount to its Common Equity Tier 1 capital in accordance with paragraph 1, the institution shall recalculate the following items by not taking into account the effects that the expected credit loss provisions that it included in its Common Equity Tier 1 capital have on those items:*

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[7] The amount of DTAs would potentially need to be reduced, depending on whether the original amount of accounting provisions gave rise to DTAs. The potential reduction in the amount of DTAs would have an impact on the amount of CET1 capital, the amount of risk weighted assets, or both and consequently all regulatory measures that rely on CET1 capital or risk-weighted assets, i.e. the various risk-based capital ratios, the leverage ratio and the large exposures limits.

[8] The amount of provisions deducted from the various exposures would be reduced by the corresponding amount of provisions that would be added back to CET1 capital. This would have an impact both on risk-weighted assets (and hence the risk-based capital ratios), on exposures for the large exposures regime, and on the exposure measure of the leverage ratio (and hence the leverage ratio itself).

[9] The amount of Tier 2 items added in accordance with point (d) of Article 62 should be reduced by the amount of the provisions that would be added back. For the SA approach an adjustment for T2 capital is not needed per se as in the EU following the RTS on credit risk adjustments all IFRS provisions are 'specific' and hence there are no 'general' credit loss provisions that can be recognised as Tier 2 capital. Any changes to Tier 2 items would have an impact on risk-based capital requirements and the large exposures limits.

(a) the amount of deferred tax assets that is deducted from Common Equity Tier 1 capital in accordance with Article 36(1)(c) or risk weighted in accordance with Article 48(4);

(b) the exposure value determined in accordance Article 111(1) for assets that are exposures for which risk weighted exposure amounts are calculated in accordance with Chapter 2 of Title II of Part Three;

(c) the amount of Tier 2 items calculated in accordance with point (d) of Article 62;

The institution shall recalculate all requirements laid down in this Regulation and Directive 2013/36/EU that use the items listed in the first subparagraph as an input.

Question 7 Are Member States of the view that the proposed list of adjustments to prevent double counting covers all relevant items? If not, which items are missing?
Question 8 Do Member States agree with the proposal not to have detailed rules on how the various adjustments should be made? If not, what alternative solution would Member States propose?
Question 9 Would Member States consider limiting the amount of adjustments in order to limit complexity and instead apply stricter transitionals? If so, please specify which adjustments are required and which adjustments could be set-off by stricter transitionals.
Question 10 Would Member States consider mandating EBA to issue guidelines to specify how the adjustments should be made? This could also be complemented with more granular adjustments to the reporting templates.

7. Disclosure requirements (Article 473a(6) of the CRR)

Transitional articles in the current CRR are subject to disclosure requirements so as to allow users of financial statements to assess the impact of institutions' use of the transitional arrangements. The forthcoming Basel text will require disclosures and EBA in its opinion proposed to cooperate with the Commission on the inclusion of the impact of the transitional in the own funds disclosures.

6. In addition to the disclosure of information required in Part Eight that would result from the application of this Article, institutions shall disclose the values of own funds, own funds requirements and the leverage ratio they would have if they did not apply this Article.

Question 11 Do Member States agree with the proposed disclosure requirement?

ANNEX I

Commission proposal

"Article 473a
Introduction of IFRS 9

1. *Until [date of application of this Article + 5 years] institutions that prepare their accounts in conformity with the international accounting standards adopted in accordance with the procedure laid down in Article 6(2) of Regulation (EC) No 1606/2002 may add to their Common Equity Tier 1 capital the amount calculated in accordance with paragraph 2 of this Article multiplied by the applicable factor laid down in paragraph 3.*
2. *The amount referred to in paragraph 1 shall be calculated as the twelve month expected credit losses determined in accordance with paragraph 5.5.5 of Commission Regulation (EU) No …. / 2016 (10) and the amount of the loss allowance for financial instruments equal to the lifetime expected losses determined in accordance with paragraph 5.5.3 of Commisison Regulation (EU) No …. / 2016 (1).*
3. *In calculating the amount referred to in paragraph 1, thefollowing factors apply:*

(a) *1 in the period from [date of application of this Article] to [date of application of this Article + 1 year - 1 day];*

(b) *0,8 in the period from [date of application of this Article + 1 year] to [date of application of this Article + 2 years - 1 day];*

(c) *0,6 in the period from [date of application of this Article +2 years] to [date of application of this Article +3 years - 1 day];*

(d) *0,4 in the period from [date of application of this Article +3 years] to [date of application of this Article +4 years - 1 day];*

(e) *0,2 in the period from [date of application of this Article +4 years] to [date of application of this Article +5 years - 1 day].*

Institutions shall include in their own funds disclosures the amount added to their Common Equity Tier 1 capital in accordance with paragraph 1."

[10] Commission Regulation (EU) No …./2016 of .. …… 2016 adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council (OJ L , ……, p.).