标普信评

S&P Global

China Ratings

New Challenges Arise for Credit Loss Provisioning Under IFRS 9 Amid COVID-19

August 12, 2020

ANALYSTS

Xiaochen Luan, CFA, FRM
Beijing
collins.luan@spgchinaratings.cn

Xuefei Zou, CPA
Beijing
eric.zou@spgchinaratings.cn

Ying Li, CFA, FRM
Beijing
ying.li@spgchinaratings.cn

We believe the credit loss provisioning under International Financial Reporting Standards 9 ("IFRS 9") has been put to test by the sudden rise of economic uncertainty caused by COVID-19. We anticipate higher short-term provisioning volatility under IFRS 9 amid the pandemic. Nevertheless, such possible elevated volatility does not have a material impact on our fundamental credit views on Chinese banks.

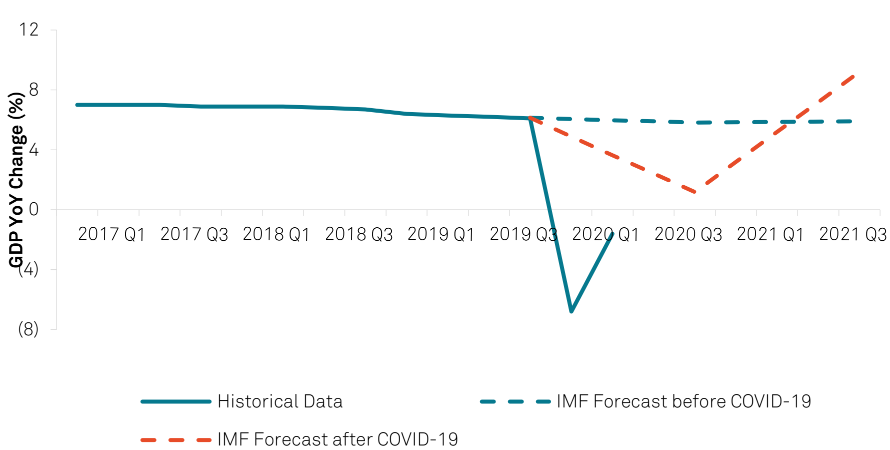
IFRS 9 intends to reflect a forward-looking view on expected credit loss ("ECL") through provisioning. Before IFRS 9, accounting rules typically conducted provisioning based on the incurred loss method. Chinese banks listed on the Hong Kong Stock Exchange have adopted IFRS 9 since January 1, 2018. About 30 Chinese banks are listed on the Hong Kong Stock Exchange, and thus need to follow IFRS 9. They accounted for about 68% of the total assets of China's commercial banking sector as of the end of 2019.

Within the IFRS 9 impairment model, forecasts on future macroeconomic conditions and provisioning method for specific credit exposure are two major factors which may lead to potential volatility in provisioning amid COVID-19.

The downward pressure and uncertainty on GDP growth would be reflected in impairment charges under IFRS 9. Forecasts on future macroeconomic conditions are an integral part of the provisioning model under IFRS 9. Economists' outlooks on GDP growth in 2020 have dropped significantly in recent months. When the lower GDP data are used as the model's input, there may be some effect on the shape of the probability of default ("PD") distribution, which may increase general provisioning pressure on all bank assets which require credit loss provisioning.

Chart 1

Example of Change of GDP Forecast Because of COVID-19



Sources: Wind, World Economic Outlook database of IMF, collected and adjusted by S&P Global (China) Ratings

The provisioning method for specific credit exposure under IFRS 9 may also amplify the cyclical nature of banks' impairment charges. Under IFRS 9, provisions are estimated based on the ECL for the entire remaining life of under-performing assets (stage 2 assets) and non-performing assets (stage 3 assets), but only based on the 12-month ECL for performing assets (stage 1 assets). The difference in ECL calculation methods when an asset migrates from stage 1 to stage 2/3 may lead to a sharp increase in impairment charges (see Appendix 1 for details). Such impact may be small in regular times, but may potentially be significant under COVID-19, with many borrowers hit by the pandemic at the same time.

In addition, making a reliable ECL forecast for borrowers in hard-hit sectors has become more challenging given the high uncertainty over the trajectory of the pandemic. The provisioning pressure on different industries varies and we anticipate higher pressure in the aviation, tourism, restaurant and recreation sectors as well as among small and medium-sized enterprises. Therefore, the provisioning pressure on banks will differ based on their respective portfolio concentration.

Due to the challenges concerning quantitative assessment, we believe, in the short term, qualitative assessment by the management is an important input in provision modeling. We expect banks' management teams to mitigate impairment charge volatility after they incorporate government support for the real economy into their assessments.

Nevertheless, from a credit perspective, the possible weakening of internal capital generation capacity resulting from higher provisioning is compensated by a corresponding increase in banks' reserve buffers. Therefore, any earning volatility caused by IFRS 9 provisioning does not have a material impact on banks' overall capitalization. It is more important to assess the actual credit cost of the pandemic, but the extent of its actual impact is still too early to tell. Before COVID-19, the initial adoption of IFRS 9 in 2018 had no significant impact on Chinese banks' capital levels (see appendix 2 for details).

This article does not constitute a rating action.

Appendix 1: Key Information Related to Credit Loss Provisioning under IFRS 9

IFRS 9 has introduced several changes to financial instruments' accounting standards, including credit loss provisioning and asset classification and measurement. We believe the most significant impact for commercial banks is on provisioning.

As IFRS 9 requires, a measure of ECL is an unbiased probability-weighted amount determined by evaluating a range of possible outcomes using reasonable and supportable information. Banks need to incorporate different forward-looking information into their ECL estimates, which requires consideration of multiple future economic scenarios. In addition, management decisions may have a material impact on ECL outcomes.

IFRS 9 also introduces the idea of a three-stage asset credit risk assessment which is critical for calculating provisioning. If an exposure's credit risk has not increased significantly since initial recognition, then the exposure is 'stage 1' and the bank's provisioning is based only on a 12-month ECL. However, if the exposure has suffered a significant increase in credit risk, then the exposure is 'stage 2' and the bank needs to provision an amount equal to lifetime ECL. If the exposure meets the definition of credit impaired (including defaults and other events that have a detrimental impact on estimated future cash flows), it is then categorized as 'stage 3' and the bank needs to recognize a provision which is the difference between all contractual cash flow receivables and cash flows that the management expected to receive (also lifetime ECL).

Therefore, the three-stage classification of assets, especially for longer-dated portfolios, can have a significant impact on provisioning when an exposure migrates from stage 1 to stage 2 or 3. The three-stage assessment also drives how credit risk exposures should be disclosed in financial statements.

The three-stage categorization of assets under IFRS 9 and the five-tier asset quality classification under regulatory framework are two separate frameworks used to assess asset quality. However, thanks to their similar definitions of asset classes, we have observed that IFRS 9 stage 2 loans are typically in line with the five-tier framework's special mention loans, and IFRS 9 stage 3 loans are typically in line with the five-tier framework's non-performing loans.

Comparison between Three-stage Loan Assessment under IFRS 9 and Five-tier Loan Classification as of End of 2019

	ICBC	CCB	ABC	BOC	PSBC	BoCom
Stage 1	95.88%	95.47%	96.19%	96.05%	98.29%	95.60%
Normal	95.85%	95.65%	96.36%	96.41%	98.48%	96.37%
Stage 2	2.69%	3.11%	2.41%	2.59%	0.82%	2.93%
Special Mention	2.71%	2.93%	2.24%	2.22%	0.66%	2.16%
Stage 3	1.43%	1.42%	1.40%	1.37%	0.89%	1.47%
Non-performing	1.43%	1.42%	1.40%	1.37%	0.86%	1.47%

Note 1: Loans classified as Fair Value Through Profit and Loss (FVTPL) under IFRS 9 are not applicable to the 3-stage classification. Any asset value change of FVTPL assets is reflected through fair value assessment. 5-tier Loan Classification is applicable to all loans.

Note 2: ICBC - Industrial and Commercial Bank of China, CCB – China Construction Bank, ABC – Agricultural Bank of China, BOC – Bank of China, PSBC-Postal Savings Bank of China (AAA_{SPC}/stable), BoCom-Bank of Communications.

Source: Public information of banks, collected and adjusted by S&P Global (China) Ratings

Management overlay is another important factor in IFRS 9 provisioning. In applying the IFRS 9 rules, management's forward -looking view on ECL should be reflected in the ECL estimates. Integrating this factor can be achieved through ECL modelling or a separate adjustment on top of the modeling results.

Appendix 2: Analysis of Mega Banks' Initial Adoption of IFRS 9

When IFRS 9 was first adopted, any change to banks' financial statements caused by its implementation was reflected in changes to their total equity. The initial implementation of IFRS 9 generally caused a decrease in banks' total equity due to heavier provisioning under IFRS 9. Take the six mega banks for example, their average total equity dropped by about 1.7% due to IFRS 9 adoption in January 2018.

Nevertheless, from a credit perspective, any weakening of the banks' equity buffer is generally balanced out by the corresponding increase in reserve buffer. Therefore, in our view, the implementation of IFRS 9 did not have any material impact on Chinese banks' economic capital base when the new rules were adopted in 2018.

Breakdown of Changes to Banks' Total Equity when IFRS 9 was Adopted on January 1, 2018

(mil. RMB)	Change in retained earnings	Change in retained earnings / retained earnings before IFRS 9	Change in other comprehensive income	Change in other comprehensive income / other comprehensive income before IFRS 9	Change in total equity	Change in total equity / total equity before IFRS 9
ICBC	(55,035)	-5.01%	22,877	36.86%	(32,190)	-1.50%
CCB	(29,352)	-3.31%	10,039	33.87%	(19,451)	-1.08%
ABC	(36,457)	-6.31%	9,891	50.15%	(26,417)	-1.85%
BOC	(41,281)	-6.38%	7,119	20.01%	(35,417)	-2.25%
PSBC	(3,218)	-3.03%	4,658	92.35%	1,381	0.32%
BoCom	(28,257)	-22.69%	1,885	65.66%	(26,426)	-3.91%

Note 1: In addition to changes in retained earnings and other comprehensive income, adopting IFRS 9 may also result in small changes in general risk provision, surplus reserves, and non-controlling interests.

Note 2: Changes in retained earnings are mainly caused by changes in the impairment of assets classified as Amortized Cost (AC) and fair value changes in assets classified as FVTPL.

Note 3: Changes in other comprehensive income are mainly caused by changes in impairment and valuation of assets classified as Fair Value through Other Comprehensive Income (FVOCI).

Source: Public information of banks, collected and adjusted by S&P Global (China) Ratings