Discussion on *"Moving towards the Expected Credit Loss Model under IFRS 9: Capital Transitional Arrangement and Bank Systematic Risk"*

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Summary of your findings- Aim of my discussion

Primary objective: *Determinants and consequences of CTA adoption*

Results:

a) *Regulatory constrained Banks are more willing to opt for the CTA;*

b) IRB Banks under SSM are more prepared to absorb capital shock and opt out CTA option

c) CTA adopters decrease systematic risk, and this is more obvious when national bank authorities are more powerful

Conclusions/contribution/implications:

From Supervision/Prudential Regulation perspective

a) *CTA is effective in bridging the regulation gap Basel-IFRS*

b) *Crucial role of Bank Authorities in monitoring Banks´ practices (related to risk taking)*

From the accounting perspective

c) "*we provide preliminary evidence of IFRS 9 ECL adoption*"

FOCUS OF MY DISCUSSION:

Claims in the paper vs Claims in the accounting literature

Some debatable claims/conclusions in the paper
Discussion from the accounting literature perspective

Claims/conclusions as stated in the paper:

FIRST- *Accounting for credit losses was identified* ***as one of the major accounting failures*** *that exacerbated the 2007–2009 financial crisis by providing untimely information about banks' credit losses,* ***creating financial instability and intensifying the procyclicality of bank lending***

SECOND- *We provide preliminary evidence that applying the new ECL model under IFRS 9 might influence bank risk taking. Indeed,* ***instead of using the higher level of managerial discretions offered by IFRS 9 to manipulate the LLA,*** *CTA adopters commit to decreasing their risk taking*

THIRD- *Our study suggests that,* ***as long as banking authorities hold effective supervisory power****, the increased tolerance through IFRS 9 ..****will not incentivise banks to engage in opportunistic behavior.***

FIRST *(claim): IAS 39* ***one of the major accounting failures, creating financial instability and intensifying the procyclicality of bank lending***

Q:

Was it really one of "the major accounting failures"?
Was IAS 39 loan impairment (incurred loss) model so implicated in the procyclicality and financial instability?
Is IFRS 9 (expected loss) model going to "solve" a the problem?

A: **From previous accounting literature (Claims and empirical evidence): NO/it depends**

It was mainly bank supervisors & regulators who complained (Hashim et al 2016, 2019)

(i) In most cases the objectives of Prudential and Accounting Regulators, not just differ, but are in contradiction (*Zeff, 2012*) at least in the short term; .. Should accounting standard setters meet the need of one set of users (e.g. bank regulators) at the expense of others (e.g. capital markets) when other sources can be used (*Barth & Landsman, 2010*), and bank regulators can easily adjust the numbers (*Acharya & Ryan, 2016*)?

(ii) Bank regulation/capital requirements might amplified procyclicality (*Gebhardt & Novotny- Farkas 2011*) even more than accounting rules (*Amel-Zadeh et al 2017*)

(iii) The accounting impairment model is unlikely to play a major role from financial stability perspective (*Benston & Wall 2005, Barth & Landsman 2010; Novotny-Farkas 2016*)

-*Procyclicality*: An expected loss model is "by nature" more procyclical during crisis. Its "positive" action is more obvious during boom because it reduces accounting profits, constraining distribution of dividends *(Novotny-Farkas 2016)* and restricting moral hazard problems with lenders (*Mora& Walker, 2015*)…BUT this can be got through other mechanisms

-*Market discipline*: Delaying expected losses recognition contributes to systemic risk (*Bushman& Williams, 2015*) so an expected loss model might enhance market discipline giving more timely information (*Stephanou 2010*), BUT

a) it depends on the way it is used and

b) it requires disclosures and transparency

(*Bushman & Williams 2012, 2015, O´Hanlon 2013*, *Novotny-Farkas 2016, Giner & Mora 2019*).

SECOND. *(conclusion)* ***instead of using the higher level of managerial discretions offered by IFRS 9 to manipulate the LLA,*** *CTA adopters commit to decreasing their risk taking*

Q: Can we infer from your results that managerial discretion was not used/is not going to be used opportunistically to manage earnings (manipulate LLA)?

The (positive) impact on risk taking (real effects) does to imply "not manipulation" of LLA for opportunistic reasons

A: **From previous accounting literature (Claims and empirical evidence): NO (in a wider sense)**

(i) Banks´ "opportunistic" earnings management through loan impairments has been "always" an issue (*Hashim et al, 2019*) which mostly depends on external factors, non related with the accounting standards "per se"… but higher discretion increases the possibility ..

(ii) IFRS 9 expected loss model (vs incurred):

- has a normative induced *(Barker & McGeachin 2015)* increase in **unconditional** (one-day losses) and conditional (earlier recognition of problems) conservatism
- has increased discretion: conditional and unconditional conservatism might be higher also in practice

Conditional conservatism (more timely recognition of losses-vis a vis gains) "on balance" has a beneficial net effect on market and contracting efficiency (*Ball et al 2015; Mora & Walker 2015*).

Unconditional conservatism (underestimation of loans value) which is the preference of Bank Regulators to build up "hidden" reserves is non-informative and allows opportunistic earnings management (*Jackson & Liu 2010, Mora & Walker 2015*) which reduces accounting quality and transparency, negatively affecting long term financial stability

THIRD. (*implication*)*…as long as banking authorities hold effective* ***supervisory power****, the increased tolerance through IFRS 9* ***will not incentivise banks to engage in opportunistic behavior.***

Q: Does effective “supervisory power” disincentive opportunistic behaviour?

A: **From previous accounting literature: (claims and empirical evidence): NO …to some extent**

(i) While IAS 39 was in placed more powerful national bank supervisors, more interference on accounting practices, worse application of IAS 39, and more income smoothing (*Gebhard & Novotny-Farkas 2011; García Osma, Mora & Porcuna 2019*)

(ii) The higher independence from politicians of powerful national bank supervisors , the lower opportunistic income smoothing (*García Osma, Mora & Porcuna 2019*)

(iii) Too much supervisory intervention to meet prudential objectives (underestimation of loans value) introduces a bias that compromises the integrity of financial reporting (*Novotny-Farkas 2016*)

In summary

- It is a very interesting and well conducted paper, with relevant contribution and implications, mostly from the prudential regulation perspective in relation with IFRS 9 implementation
- It highlights interesting controversial and debatable issues on IFRS 9-ECL model, its practical implementation, and the role of bank supervisors in banks´ accounting that I analysed from the accounting literature perspective:

First: *IAS 39 one of the major accounting failures, creating financial instability and intensifying the procyclicality of bank lending?*

IAS 39 was not so much implied in the financial crisis as "some" claimed, and the ECL might enhance market discipline by giving more timely information about losses but, it depends on the way it is used ….

Second: *Banks did not manipulate LLA? Is CTA adopters 'reduction of risk a free-of-cost benefit for financial stability?*

…because higher managerial discretion allows higher opportunistic earnings management, which can negatively affect long term financial stability.

Third: *Bank authorities having a positive impact on IFRS 9 implementation*?

..**And too much bank supervisors/regulators´ interference in accounting (rules or/and practice) might compromise integrity of financial reporting, being the political independence of the supervisor clearly related with that integrity**

Thank you very much!

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