Financial reporting - a tool to underpin financial stability in times of inflation

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The cost of borrowing was anchored at record lows for a decade. Families and many business sectors, such as the housing market, benefitted from cheap credit.

Things rapidly changed last year. The effects are already felt and the financial reporting from companies across Europe started to cast a magnifying glass on those effects.

In its protective role for the euro, the ESM pays close attention to financial reporting and stands ready to support financial stability within the currency union, drawing upon its available tools. The ESM is already able to help euro countries who have lost or are at risk of losing market access to investors or help them maintain access to market financing at good terms. Upon Treaty ratification, the ESM will also be able to help the Single Resolution Fund which supports European banks.

Proper accounting practices help to avoid or limit financial and non-financial problems. Recent reforms have attempted to beef up the International Financial Reporting Standards (IFRS), following the global financial catastrophe that unfolded in 2008. With the return of inflation, the effectiveness of those reforms may now be tested.

A cycle has just ended

The last decade's very low (even negative) interest rates followed the 2008 Global Financial Crisis, which was sparked one year earlier by the 'subprime' mortgage crisis in the US. The crisis, fuelled by issues surrounding credit risk and asset valuation, was caused by the collapse of the credit and investment chain in the interbank market.

The subsequent euro sovereign debt crisis led to the creation of the European Financial Stability Facility in 2010, and its successor ESM followed in 2012. They have provided a safety net to euro area countries.

Ten years later, the global economy was about to finally recover back to trend levels when it was once again knocked down, by the Covid-19 pandemic first and later the energy crisis, fuelled by conflict in Ukraine. Both crises contributed to a rapid spike in inflation, which triggered a fast succession of interest rate hikes.

Everyone in the economy is now dealing with the rise in the cost of living and cost of credit, from families and corporates to banks and sovereigns. In the case of sovereigns, the ESM is vigilant through its monitoring tools.

Financial reporting rules have been forged through crises

Much has changed since the mortgage crisis began in the United States in 2007. The global economic and financial crisis that followed in 2008 still came as an unexpected and weighty hit that was not signalled by financial reporting.

At that time, the main rule to value financial assets within the IFRS framework that accountants used worldwide was IAS39. During the crisis, it was criticised for leading to recognition of valuation losses only at the last steps of the credit deterioration process, therefore failing to fully achieve a true and fair view[1] and contributing to the pro-cyclical effect of loss recording.[2]

In this context, the G20 exceptionally talked about accounting rules in their London meeting in April 2009 and recommended to improve standards on valuation and provisioning.[3]

A new standard, the IFRS 9, entered into force on 1 January 2018, to replace the previous rule. It introduced an Expected Credit Loss (ECL) model that required lenders, through statistical and forward-looking methodologies, to assess and record the expected credit loss on a time horizon that can vary from one year to assets' entire lifetime, depending on the assessed credit risk. This was a remarkable change from the previous rule that only required recognition of losses when the credit deterioration was actually incurred.

This change brought a significant shift for lenders' books, as they were forced to move from a primarily retrospective assessment to a forward-looking assessment, where 'forward' can mean many years ahead.

When financial stability is at stake, accounting and financial reporting rules play a crucial role in ensuring a safe and transparent environment. Accuracy and comparability are key elements. But their scope to introduce the benefit of benchmarking and targets can be widely achieved only through definition and application of clear and harmonised standards, as the updated rules intend to deliver. It is clear though that financial reporting alone cannot avert a crisis, and this is where the ESM can help if requested.

A moment of truth?

The current rules' effectiveness is being tested and may reveal whether the efforts made to implement them pay off. Especially, to see how the effects of higher interest rates will be reflected in lenders' accounts. It is also the first time since 2008 that signs of global banking turmoil have appeared - as described in a recently published ESM blog - and the first time since the introduction of the ECL model.

On top of higher borrowing cost and tougher credit conditions, labour costs have significantly increased as well[4], following the spike in inflation. This has further increased the operating costs in many industries.

Borrowers (households and corporates) may start facing stretched cashflows. Lenders are likely to see increasing credit risk in their loan portfolios in the coming quarters, although they are currently benefitting from higher interest margins.

If the updated financial reporting rules promptly catch the trend, it should produce some anti-cyclical effects on lenders' accounts. Hence, if the worst scenario comes, lenders will have already managed the related losses in their books and hopefully put in place mitigating measures. This would help avoid another sudden financial shock such as in 2008.

In this respect, the 2023 half-year earnings season showed mixed results. This may be explained by several factors. Borrowers may prove resilient, at least temporarily. The timing and amount of provisions can still vary significantly between reporting periods. Moreover, interpretation plays a role under the updated financial reporting rules too, as judgement remains an important conclusion.

It will therefore be extremely important to understand which of those factors will dominate in the future and to see how much of the risk was accurately captured by the financial reporting. Timing plays a crucial role here to avoid jumping to premature conclusions.

Were the risks to mount, the ESM has a pivotal role in helping restore financial stability.

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Footnotes

[1] ACCA (2014) True and Fair view statement .

[2] ECB (2019) The procyclicality of banking: evidence from the euro area .

[3] IMF (2009) London Summit - Leaders' Statement .

[4] Eurostat (2023) Labour cost index - recent trends .

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