

PROVISIONS AND THEIR ROLE IN TIME OF CRISIS

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ABSTRACT

Provisions help organizations manage uncertainty and reduce the economic impact of shocks, particularly during crises. As defined by IAS 37, provisions are liabilities with uncertain amounts or timing and are recognized when a present obligation exists and an outflow of resources is probable. The global financial crisis (2007-2009) demonstrated that the traditional incurred-loss accounting model delayed loss recognition, thereby increasing pressure on bank balance sheets. In response to these shortcomings, IFRS 9 introduced the expected credit loss (ECL) model, which facilitates earlier recognition of asset quality deterioration and aims to reduce procyclicality. Empirical studies, particularly during the COVID-19 pandemic, show that banks increased provisions rapidly in response to heightened economic uncertainty. However, provisioning decisions continue to vary due to managerial discretion and differences in macroeconomic scenarios, which affect the consistency and timeliness of provisions. This article examines how provisions function during crises, the evolution of the regulatory framework, and their broader impact on financial stability.

KEYWORDS: provisions, expected loss, financial stability, economic crisis

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1. Introduction

Provisions represent one of the most important accounting instruments through which economic entities manage uncertainty and risks related to future obligations. Essentially, they reflect estimates of potential losses or future resource outflows, the amounts and timing of which are uncertain. IAS 37 provides the conceptual foundation for recognising and measuring provisions, defining them as present obligations arising from past events, for which an outflow of resources is probable and can be reliably estimated (IASB, 2020).

The relevance of provisions becomes particularly evident during periods of economic stress, when uncertainty increases and financial markets become more

volatile. In such circumstances, provisions play a critical role in reflecting emerging risks, protecting institutional capital, and ensuring a true and fair view of financial positions. The global financial crisis of 2007-2009 clearly exposed the limitations of the accounting framework in force at that time. The incurred-loss model required objective evidence of impairment before recognising losses, which led to delayed provisioning and amplified vulnerabilities within bank balance sheets (Laeven & Majnoni, 2003; Gebhardt & Novotny-Farkas, 2011).

In response to these shortcomings, the International Accounting Standards Board introduced IFRS 9 – Financial Instruments, replacing the incurred-loss model with the

expected credit loss (ECL) approach. This model enables earlier recognition of credit impairment by integrating historical, current, and forward-looking information into loss estimates (IASB, 2014). IFRS 9 therefore represents a major regulatory shift aimed at improving the quality of financial information and mitigating the procyclicality of provisioning.

At the same time, economic literature emphasises that provisions can significantly affect the behaviour of financial institutions. When established prudently and at an early stage, provisions can act as a risk buffer. However, if they are recognised too late or in an excessively abrupt manner, they may contribute to financial instability (Beatty & Liao, 2014). Furthermore, numerous studies show that management may use provisions discretionarily, either for income smoothing or in response to supervisory pressures (Curcio et al., 2017).

The COVID-19 pandemic offered a new opportunity to observe the functioning of provisions under conditions of extreme economic stress. Evidence suggests that IFRS 9 enabled banks to increase provisions rapidly in early 2020, but also revealed substantial heterogeneity in provisioning practices across institutions, driven by differences in risk models and macroeconomic scenarios (Araujo et al., 2021; Behn & Wiolski, 2023).

This article analyses the role of provisions in crisis periods by examining two main aspects: first, the conceptual and regulatory framework provided by IAS 37 and IFRS 9; second, empirical evidence from two major crises – the global financial crisis and the COVID-19 pandemic. The objective is to assess the extent to which provisions support financial stability and to identify the main challenges related to their recognition and estimation.

To achieve this objective, the paper is structured as follows. Section 2 presents the theoretical framework of provisions and the evolution of accounting regulations. Section

3 examines the behaviour of provisions during crises based on empirical evidence, including a descriptive comparative analysis. Section 4 concludes and outlines directions for improving the provisioning framework.

2. Theoretical Framework of Provisions

2.1. Provisions within the Meaning of IAS 37

IAS 37 governs the accounting treatment of provisions, contingent liabilities, and contingent assets. According to the standard, a provision is recognised when an entity has a present obligation arising from a past event, an outflow of economic resources is probable, and the amount can be reliably estimated (IASB, 2020).

Under stable economic conditions, applying these criteria is relatively straightforward. However, during crises characterised by heightened uncertainty and volatility, estimating provisions becomes considerably more complex. Rapid changes in macroeconomic conditions affect the probability and magnitude of future outflows, increasing reliance on professional judgement and frequent model updates.

IAS 37 also seeks to prevent opportunistic behaviour related to profit manipulation. Despite its rigorous framework, empirical evidence shows that managers – particularly in the banking sector – may use provisions for income smoothing, especially during periods of heightened pressure on financial performance (Curcio et al., 2017). In crisis periods, this risk intensifies, as institutions face incentives either to under-provision, thereby overstating financial strength, or to over-provision in order to create buffers for future periods.

Through disclosure requirements and transparency obligations, IAS 37 helps maintain users' confidence in financial reporting, which is crucial in an economic environment affected by crises.

2.2. Transition from Incurred Loss to Expected Loss: IFRS 9

The global financial crisis revealed significant weaknesses in the incurred-loss model previously applied under IAS 39. Numerous studies have shown that banks tended to recognise credit losses too late, often only after asset quality deterioration became evident (Laeven & Majnoni, 2003; Gebhardt & Novotny-Farkas, 2011). This delayed recognition contributed to asset overvaluation and abrupt provisioning adjustments during downturns.

IFRS 9 replaced this approach with the expected credit loss model, which requires institutions to recognise losses based on expectations rather than realised events (IASB, 2014).

The ECL framework is built on three core principles: the integration of historical, current, and forward-looking information; the staging of financial assets according to credit risk deterioration; and the continuous updating of estimates over the life of financial instruments.

This represents a conceptual advancement, as it forces banks to incorporate macroeconomic forecasts – such as GDP growth, unemployment, inflation, and interest rates – into provisioning decisions. However, the literature also highlights important limitations. While IFRS 9 reduces delays in loss recognition, it increases reliance on managerial judgement, which may undermine comparability across institutions (Novotny-Farkas, 2016). Differences in how banks define “significant increase in credit risk” can lead to substantial variation in provisioning outcomes (Behn & Couaillier, 2023).

2.3. Provisions and Financial Stability

Beyond their microeconomic role, provisions have a significant macroeconomic and prudential dimension. The Bank for International Settlements emphasises that timely and adequate

provisioning strengthens the resilience of financial institutions and helps absorb adverse shocks (BCBS, 2015).

Nevertheless, provisions often exhibit procyclical behaviour. Under the incurred-loss model, provisions increased substantially during recessions, exacerbating stress within the banking system and restricting credit supply (Beatty & Liao, 2014). IFRS 9 was designed to mitigate this effect by encouraging earlier loss recognition.

In practice, the effectiveness of the ECL model depends on several factors: the quality of risk models, the reliability of macroeconomic forecasts, government interventions during crises, and the robustness of internal governance structures. As a result, while IFRS 9 improves risk anticipation, uncertainty and heterogeneity remain significant challenges during periods of stress.

3. Provisions in Times of Crisis – Empirical Evidence

Provisions are one of the main tools through which financial institutions absorb economic shocks, but their behavior in times of crisis is often complex, variable, and influenced by macroeconomic, prudential, and managerial factors. This section analyzes how provisions have evolved in two major crisis contexts: the 2007-2009 global financial crisis and the COVID-19 pandemic, as well as the discussion of the pro-cyclicality of provisions – a critical element for financial stability.

3.1. Global Financial Crisis (2007-2009)

During the global financial crisis, the incurred-loss model delayed the recognition of credit losses, as banks were required to wait for objective evidence of impairment. This led to a sharp increase in provisions only after non-performing loans had already risen significantly (Laeven & Majnoni, 2003).

Gebhardt and Novotny-Farkas (2011) show that European banks recognised losses later than it would have been prudent, resulting in sudden and destabilising adjustments in 2008-2009. Curcio et al. (2017) further demonstrate that provisioning practices were influenced by discretionary behaviour, intensifying balance-sheet stress and constraining credit supply at a critical moment.

These shortcomings were explicitly acknowledged by international regulators, prompting the replacement of IAS 39 with IFRS 9.

3.2. Provisioning in the COVID-19 Pandemic under IFRS 9

The COVID-19 pandemic constituted the first major stress test for the IFRS 9 framework. In contrast to the previous crisis, banks increased provisions rapidly in early 2020, reflecting deteriorating macroeconomic conditions and rising default probabilities (Araujo et al., 2021).

However, the response varied significantly across institutions. European banks displayed different transition patterns between ECL stages, largely depending on how significant credit deterioration was defined and how macroeconomic scenarios were constructed (Behn & Couaillier, 2023). Government interventions – such as state guarantees and repayment moratoria – temporarily reduced default risk and led some banks to adjust provisions downward later in 2020.

This descriptive evidence illustrates both the strengths of IFRS 9, in terms of responsiveness, and its limitations, notably the high sensitivity of provisions to assumptions and public policy measures.

3.3. Procyclicality and Financial Stability Implications

Although IFRS 9 aims to reduce procyclicality, empirical findings remain mixed. Early recognition of losses can act as a countercyclical buffer, but excessive

uncertainty during severe crises may still generate conservative or uneven responses across banks.

The BIS (BCBS, 2015) stresses that mitigating procyclicality requires robust macroeconomic scenarios and consistent supervisory oversight. If risks are underestimated during expansionary phases, subsequent adjustments during downturns can still be destabilising.

In conclusion, empirical evidence shows that provisions:

- can function as a countercyclical buffer if recognized early (Behn & Couaillier, 2023; BCBS, 2015);

- have a key role in balance sheet transparency, influencing investor confidence;

- can contribute to instability, if established too late or too abruptly (Laeven & Majnoni, 2003);

- are strongly influenced by managerial discretion, even under IFRS 9;

- are sensitive to macroeconomic scenarios and government interventions.

Provisions are not just an accounting tool, but a central element of the financial stability architecture. The way they are implemented can mitigate or amplify the effects of a crisis.

4. The Role of Expected Credit Loss Provisions in Times of Crisis: Evidence from a Systemically Important European Bank during the COVID-19 Pandemic

The COVID-19 pandemic constituted an unprecedented systemic shock to the European banking sector, marked by a sharp increase in macroeconomic uncertainty, widespread disruptions to economic activity, and a deterioration in borrowers' repayment capacity. Under these conditions, the forward-looking impairment framework introduced by IFRS 9 – *Financial Instruments* was subjected to a major empirical stress test, offering valuable insights into the functioning of expected credit loss (ECL) provisioning during a severe economic downturn.

This section examines, through an applied case study, the effective role of ECL provisions during the COVID-19 crisis, with a particular focus on transitions across IFRS 9 stages, the impact of government support measures, and subsequent adjustments to provisioning levels. The analysis is conducted on Deutsche Bank AG, a global systemically important bank (G-SIB), using publicly available audited data covering the period 2019-2021.

The empirical assessment draws on information disclosed in Deutsche Bank's consolidated annual reports for the financial years 2019, 2020, and 2021, prepared in accordance with International Financial Reporting Standards (IFRS). The analysis focuses on the following key variables:

- *the gross carrying amount (GCA)* of financial assets measured at amortised cost, disaggregated by IFRS 9 stages (Stage 1, Stage 2, and Stage 3);
- *allowances for expected credit losses (ECL)* corresponding to each stage;
- *provisions for credit losses (PCL)* recognised in the statement of profit or loss;
- *exposures* subject to payment moratoria, COVID-19-related forbearance measures, and loans guaranteed under government schemes, together with their corresponding IFRS 9 classifications.

The interpretation of results is undertaken in conjunction with the guidelines issued by the European Banking Authority (EBA, 2020) on payment moratoria and communications from the European Central Bank (ECB, 2020) regarding supervisory flexibility in response to the pandemic.

4.1. Evolution of Exposures and Transitions across IFRS 9 Stages

4.1.1. Migration of Exposures in 2020: Materialisation of the Pandemic Shock

Compared with 2019, the data for 2020 reveal a significant structural shift in the distribution of exposures across IFRS 9 stages. While the volume of assets classified

in Stage 1 remained broadly stable, Stage 2 exposures increased markedly, reflecting a significant increase in credit risk (SICR) without the immediate recognition of default. At the same time, Stage 3 exposures also recorded a notable rise, indicating the materialisation of actual defaults.

This migration pattern is characteristic of a systemic crisis. The deterioration of macroeconomic conditions and sectoral outlooks initially leads to the reclassification of performing exposures into Stage 2, prior to the crystallisation of payment defaults. In this respect, IFRS 9 operates as an early risk recognition mechanism, in contrast to accounting models based exclusively on incurred losses.

4.1.2. Impact on Expected Credit Loss Provisions

The evolution of total expected credit loss (ECL) allowances recognised on Deutsche Bank's balance sheet over the period 2019-2021 illustrates the responsiveness of the IFRS 9 framework to rapidly changing economic conditions. The IFRS 9 allowance increased from EUR 4.09 billion in 2019 to EUR 4.95 billion in 2020, before declining marginally to EUR 4.90 billion in 2021.

The substantial increase in provisions recorded in 2020 – amounting to an absolute rise of EUR 0.86 billion (+21%) – reflects the bank's forward-looking response to the sharp deterioration of the macroeconomic environment caused by the COVID-19 pandemic. The elevated level of provisions maintained in 2021 points to a prudent stance, as credit risk, although stabilised, had not fully reverted to pre-pandemic levels.

Notably, Deutsche Bank's disclosures indicate that a significant share of the increase in Stage 2 provisions was explicitly attributable to updates in macroeconomic outlooks, highlighting the central role of professional judgement and forward-looking assumptions within the IFRS 9 impairment framework.

4.2. Government Support Measures and Their Effect on ECL

4.2.1. Payment Moratoria and Forbearance Measures during the Pandemic

In 2020, Deutsche Bank reported a substantial volume of exposures subject to payment moratoria and pandemic-related forbearance measures. In line with EBA guidance, the application of general, non-debtor-specific moratoria did not automatically trigger the classification of exposures as defaulted or their treatment as traditional forbearance. Nevertheless, these exposures were subject to enhanced monitoring and, in many cases, were reclassified into Stage 2 as a consequence of increased credit risk.

A comparative assessment of the 2020-2021 period shows that, although the overall volume of exposures under moratoria declined in 2021, the level of associated provisions increased. This development reflects a post-moratorium “clarification effect”: as temporary support measures were withdrawn, a proportion of borrowers failed to resume sustainable repayment behaviour, resulting in the migration of certain exposures from Stage 2 to Stage 3.

4.2.2. Loans Guaranteed under Government Schemes

A distinctive component of the policy response to the COVID-19 crisis was the expansion of state-guaranteed lending programmes, such as those implemented through KfW in Germany. Empirical evidence indicates that these exposures were associated with relatively low levels of expected credit losses, primarily due to the reduction in loss given default (LGD) provided by public guarantees. Consequently, the ECL recognised for these loans was significantly lower than that recorded for other portfolio segments, confirming the mitigating role of public policy interventions in limiting balance sheet deterioration.

4.3. Subsequent Adjustment of Provisions during the Recalibration Phase (2021)

In 2021, against the backdrop of economic stabilisation and greater visibility regarding the actual impact of the pandemic on borrowers, annual expenses related to provisions for credit losses (PCL) declined substantially compared with 2020. Despite this reduction, the total allowance recognised on the balance sheet remained relatively stable, suggesting that the adjustment occurred primarily through a moderation in the pace of new provisioning rather than through large-scale reversals.

This pattern supports the view that IFRS 9 provisions functioned as a countercyclical mechanism: enabling rapid recognition of risk during the acute phase of the crisis, followed by a cautious recalibration as uncertainty receded and portfolio performance became more observable.

4.4. Conclusions of the Case Study

The case study of Deutsche Bank provides empirical evidence on the role of expected credit loss provisions in absorbing the shock generated by the COVID-19 pandemic. Three main conclusions emerge.

First, the pronounced migration of exposures from Stage 1 to Stage 2 in 2020 represented the primary channel through which the crisis translated into higher provisioning levels, ahead of the materialisation of defaults.

Second, government support measures – particularly payment moratoria and public guarantee schemes – significantly influenced ECL dynamics by delaying or limiting credit deterioration, without removing the need for ongoing risk assessment.

Third, the subsequent adjustments to provisions observed in 2021 underscore the dynamic and forward-looking nature of the IFRS 9 impairment model, as well as the importance of professional judgement in estimating expected credit losses.

Overall, the evidence suggests that IFRS 9 provisions played a key role in supporting financial stability by enhancing transparency and reinforcing the resilience of the European banking system during an unprecedented crisis.

5. Recommendations and Implications for Practice

The theoretical and empirical findings regarding the role of provisions during crisis periods underline the need for both structural and operational improvements in the provisioning framework. Strengthening provisioning practices is essential not only to enhance the efficiency of financial institutions but also to reduce systemic vulnerabilities and support overall financial stability. The recommendations presented below address financial institutions, regulators, and accounting standard setters, emphasising the importance of coordinated and forward-looking approaches.

5.1. Improving the Quality of Risk Models and ECL Estimates

The implementation of IFRS 9 relies on complex expected credit loss models that incorporate historical, current, and forward-looking information. To enhance the reliability and consistency of ECL estimates, banks should further strengthen their analytical capabilities by integrating advanced statistical techniques, sensitivity analyses, and, where appropriate, machine-learning tools.

In addition, independent model validation should be reinforced to ensure the accuracy and robustness of estimates, particularly under adverse economic scenarios (Behn & Couaillier, 2023). Improving data quality through integrated information systems is equally important, as such systems enable the continuous collection, updating, and monitoring of key variables used in ECL calculations. Together, these measures help reduce excessive variability across institutions and limit overreliance on managerial judgement.

5.2. Standardisation and Transparency of Macroeconomic Scenarios

Macroeconomic scenarios constitute a core element of the ECL framework. However, significant methodological differences in scenario design and calibration can undermine the comparability of provisioning outcomes.

To address this issue, several actions are recommended. Prudential authorities should provide more detailed guidance regarding the selection of key macroeconomic parameters, acceptable uncertainty ranges, and the frequency of scenario updates (BCBS, 2015).

At the same time, financial institutions should apply a coherent set of scenarios – typically baseline, optimistic, and pessimistic – and disclose the underlying methodologies transparently to facilitate comparability across banks. A more standardised and transparent approach to scenario construction enhances the credibility and interpretability of ECL estimates.

5.3. Strengthening Internal Governance over Provisioning

Effective provisioning requires a robust internal governance framework that ensures consistency, accountability, and independence in decision-making. In this regard, internal risk committees should regularly review the assumptions, parameters, and outcomes of ECL models. Internal audit functions should conduct periodic assessments of data integrity and methodological consistency.

Moreover, a clear separation between business functions and risk management units is essential to reduce potential pressures on provisioning decisions. Strengthening governance arrangements in this manner limits the discretionary use of provisions for income smoothing and reinforces investor and stakeholder confidence in reported financial information.

5.4. Enhancing Coordination between Accounting and Prudential Regulation

The COVID-19 pandemic demonstrated that public policy interventions – such as state guarantees and repayment moratoria – can directly influence provisioning outcomes (Araujo et al., 2021). This experience highlights the need for closer coordination between accounting standards and prudential regulation.

Ongoing dialogue between standard setters and supervisory authorities is necessary to ensure alignment between IFRS 9 requirements and Basel III capital regulations. Supervisors should also assess whether provisions accumulated during expansionary periods are sufficient to absorb losses in severe downturns. Improved coherence between accounting and prudential frameworks helps prevent procyclical responses and supports financial system stability.

5.5. Promoting Transparency and Effective Communication with Financial Statement Users

Transparency remains a fundamental principle of high-quality financial reporting. Banks should therefore provide comprehensive disclosures regarding their ECL methodologies, including key assumptions related to probability of default, loss given default, and exposure at default.

In addition, qualitative disclosures should explain how exceptional events – such as pandemics or geopolitical crises – have affected provisioning levels. Enhanced transparency enables investors and analysts to better assess credit risk and institutional resilience, thereby reducing information asymmetries and strengthening trust in the financial system.

5.6. Developing a Proactive and Countercyclical Provisioning Approach

For provisions to function effectively as shock absorbers during crises, institutions must adopt a proactive and countercyclical approach. This involves building adequate provisions during expansionary phases, when risks begin to accumulate, even if losses have not yet materialised (Laeven & Majnoni, 2003).

Internal models should be reviewed and recalibrated periodically to ensure that they accurately reflect evolving risk conditions and the economic cycle. Furthermore, authorities may consider supplementary buffer mechanisms, such as dynamic provisioning frameworks implemented in certain jurisdictions.

Such measures help alleviate pressure on capital during downturns and enhance the resilience of the financial system.

In summary, the recommendations outlined above aim to reinforce the role of provisions as a key instrument for financial stability. The effectiveness of provisioning ultimately depends on several interrelated factors: the quality of data and models, transparency of processes, prudent supervision, regulatory coherence, and the ability of institutions to anticipate economic cycles. Implementing these measures strengthens the resilience of financial institutions and improves their capacity to respond effectively to future economic crises.

6. Conclusions

Provisions are a central accounting and prudential tool for managing risk and supporting financial stability, particularly in times of crisis. IAS 37 provides the conceptual basis for recognising uncertain liabilities, while IFRS 9 represents a significant improvement by enabling earlier recognition of credit losses through the ECL model.

Empirical evidence from the global financial crisis and the COVID-19 pandemic shows that delayed provisioning amplifies financial stress, whereas timely and prudent recognition can enhance resilience. However, the effectiveness of IFRS 9 depends heavily on implementation quality, data reliability, governance structures, and supervisory coordination.

The persistence of heterogeneity in provisioning practices suggests that managerial discretion remains a critical factor. Strengthening model validation, improving transparency, standardising macroeconomic scenarios, and enhancing coordination between accounting and

prudential regulation are essential steps to reinforce the stabilising role of provisions.

When applied rigorously, provisions support financial system resilience, sustain credit provision, and mitigate the adverse effects of economic crises on the real economy.

From a policy perspective, the findings suggest that strengthening coordination between accounting standards and prudential regulation is essential to ensure that provisioning supports sustainable post-crisis transitions. Policies encouraging conservative provisioning during expansionary periods can enhance banks' resilience and reduce the need for abrupt adjustments during downturns.

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