BANKING ON KNOWLEDGE

Banks are transforming to address IFRS 9 requirements

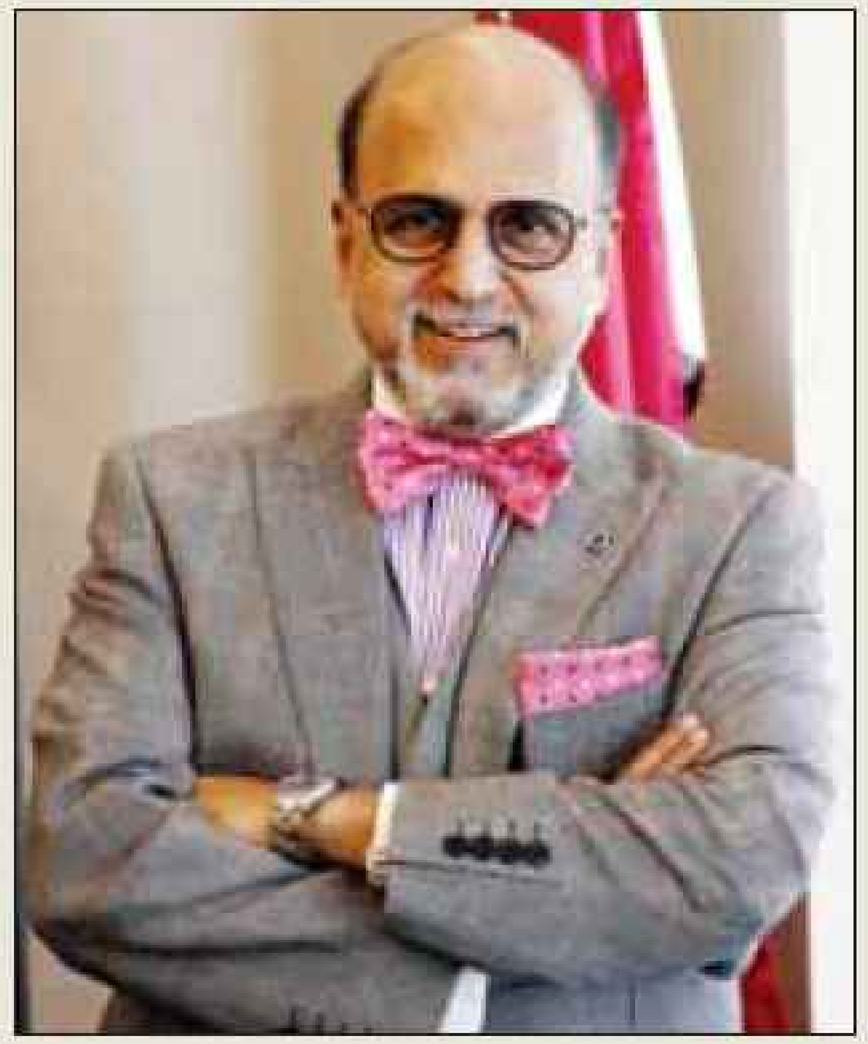
By Dr R Seetharaman

The International Financial Reporting Standard 9 — Financial instruments (IFRS 9) has replaced most of the guidance in International Accounting Standard 39 (IAS 39). This will be for accounting periods beginning from this year. This included a new impairment model which will result in earlier recognition of losses. The more principles-based approach of IFRS 9 requires careful use of judgment in its application.

Financial assets are classified in IFRS 9 according to their contractual cash flow characteristics and the business models under which they are held. Instruments will be classified either at amortised cost, the newly established measurement category fair value through other comprehensive income (FVOCI), or fair value through profit or loss (FVTPL).

The three business models which drive the accounting classification of financial assets under IFRS 9 are Held to Collect business model, Held to Collect and Sale business model and Trading model.

Held to Collect business model — A practice to collect contractual cash flows to recover investment in an asset. The assets which follows this are deposits with QCB



and similar institutions. Its measurement is at amortised cost.

Held to Collect and Sale business model — A practice to collect contractual cash flows from the asset or may be sold. It may be bank's liquidity portfolio. It's measurement category is by fair value through other comprehensive income (FVOCI).

Trading model — This mainly comprise of assets held for short term profit-making. It's measurement is by fair value through profit or loss (FVTPL).

Debt instruments could get classified in any of the above three business models. Equity instruments can be classified either in fair value through other comprehensive income (FVOCI) or fair value through profit or loss (FVTPL).

According to S&P, the effect of classification and measurement on investments was limited on its rated Gulf banks, accounting for around 4% of the total impact charged to retained earnings, on average. This stemmed from the relatively strong credit quality of rated banks' investment portfolios and their straightforward business models.

In the earlier incurred credit loss model, the bank provided for a loan loss when such an event occurs. However, under the expected credit loss model in IFRS 9, the bank is expected to anticipate that such an event could occur and therefore provide for losses earlier than previously.

The new standard outlines a 'three-stage' model for impairment based on changes in credit quality since initial recognition:

Stage-1 includes financial instruments that have not had a significant increase in credit risk since initial recognition or have low credit risk at the reporting date. For these assets, 12-month expected credit losses ('ECL') are recognised and interest revenue is calculated on the gross carrying amount of the asset.

Stage-2 includes financial instruments that have had a significant deterioration in credit risk since initial recognition, but that do not have objective evidence of impairment. For these assets, lifetime ECL are recognised, but interest revenue is still calculated on the gross carrying amount of the asset.

Stage-3 includes financial assets that have objective evidence of impairment at the reporting date. For these assets, lifetime ECL are recognised and interest revenue is calculated on the net carrying amount.

The most significant financial implications of IFRS 9 as against IAS 39 on impairment arise from the introduction of Stage-2. It is therefore critical as to how to implement the "significant deterioration" criteria for the Stage-2 allocation of assets.

Banks can use the general model to measure ECL for assets in Stage-1 and Stage-2: Probability of Default (loss given default) Exposure at Default. For Stage-3, banks are required to define the definition of default in accordance's with QCB instructions. Banks are to estimate possibility of default (PD) based on all relevant information. In determining key indicators of credit deterioration, external indicators, internal indicators and borrower-related indicators are to be considered.

The external key indicators include external ratings, market factors, macroeconomic developments and industry factors.

The internal Key indicators include internal rating, credit risk judgement, debt restructuring and legal developments.

The borrower-related key indicators include financial and management performance and collateral values.

The new ECL model under IFRS 9 will result in higher provisions relative to current IAS 39 incurred model.

S&P said the Gulf banks' implementation of IFRS 9 on January 1, 2018, led to an additional provision of 1.1% of total loans, which is equivalent to one-third of their net operating income before loan loss provisions.

Rated banks in Qatar were the most affected, as S&P predicted in 2017. The average additional provision amounted to 1.5% of total loans, with the minimum increase at 0.5% and maximum increase at 2.8%, the shift in the operating environment after several Arab countries unjustly boycotted Qatar and, in particular, the pressure on Qatar's real estate and hospitality sectors are continuing to exacerbate banks' provisioning needs.

Taking into consideration the IFRS 9 requirements, most of the banks in the region have evaluated the effects on banks' regulatory capital and the volatility in provisions impacting the financial statements, the effects of IFRS 9 on business planning and forecasting and on product pricing, and re-adjustment of key performance indicators. The industry and macroeconomic indicators are also captured in the ECL modelling exercise, with focus on shifts from Stage-1 to Stage-2 across various sectors.

System- and data-gathering capabilities and governance frameworks have been re-defined in light of IFRS 9 requirements. On the whole, the banks are transforming to address the IFRS 9 requirements.

■ *The author is Group CEO of Doha Bank.*