BANKING ON KNOWLEDGE

IFRS 9 — a paradigm shift for GCC financial institutions

By Dr R Seetharaman

The International Financial Reporting Standard 9 — Financial instruments (IFRS 9) replaces most of the guidance in International Accounting Standard 39 (IAS 39). This includes a new impairment model which will result in earlier recognition of losses. The compliance deadline for all the banks will be accounting periods beginning on or after January 1, 2018. The more principles-based approach of IFRS 9 requires the careful use of judgment in its application.

In the current incurred credit loss model, the bank provides 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

that 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 (PDs) based on all relevant information. It requires banks to map internal credit risk rating models to Moody's credit rating definitions. It also requires banks to map their short term credit rating system to Moody's long term credit rating using the Moody's Linkage with short term rating scale.

It is expected that new ECL model under IFRS 9 will result in higher provisions relative to current IAS 39 incurred model. A major concern for banks will be how the new standard affects regulatory capital ratios. Banks will need to factor this into their capital planning. Stakeholders will be looking for information on expected capital impact in financial statements.

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 — 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).

Banks need to have IFRS 9 project steering committee to manage the implementation process of this standard. It should have members from finance, risk, compliance, internal audit and IT for this committee.

This committee can periodically update the Board of Directors on the implementation process. The key areas that management should be aware from IFRS 9 are as follows:

The effects of IFRS 9 on business planning and forecasting and on product pricing. The need for re-adjustment of key performance indicators, the effects on bank's regulatory capital and the volatility in provisions impacting the financial statements. The industry and macroeconomic indicators should be captured accurately in the ECL modelling exercise. The system and data gathering capabilities required for IFRS 9 should be developed by banks. The impact of IFRS 9 on governance frameworks should also be evaluated.

On the whole, IFRS 9 is a paradigm shift for GCC banks and other financial institutions.

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