IFRS 9 FROM PROJECT TO IMPLEMENTATION CHALLENGE FOR THE BANKING SYSTEM

Elena Barsu *(ebarsu@yahoo.com)*

Abstract

International Financial Reporting Standards (IFRS) are developed by the International Accounting Standards Board (IASB) and aim to provide high quality, transparent and comparable information in financial statements and other financial reporting to help investors, others participants in global capital spots and other users of financial information to make economic decisions. The global financial crisis has demonstrated the need to find solutions for correctly measuring credit risk. Starting with 2009, the IASB has developed new principles and models for timely recognition of credit losses. This is how IFRS 9 - Financial Instruments, which includes IAS 39 - Financial Instruments: Recognition and Measurement. The IFRS 9 version issued in July 2014 replaces all other versions and is effective from January 1, 2018.

Key words: *IFRS, valuation, derecognition, fair value, time value of money, cash flow test, derivation, hedge accounting.*

JEL Classification: F21, G12

Introduction

The banking system in Romania applies International Financial Reporting Standards (IFRS) as of January 1, 2012, implicitly applying IFRS 9 becomes a legal obligation not only a need for credit risk management. For the implementation of IFRS 9, banks need to make extensive analyzes of the portfolio of loans, assets and financial liabilities to make decisions about the implementation of mathematical and computer models so that credit risk can be correctly calculated as IFRS 9 introduces new classification criteria and the measurement of financial instruments in conjunction with the Bank's objectives / strategies (Business Model) and the contractual characteristics that generate cash flows (SPPI Test principal and interest payments only).

Literature review

Dumitrescu (2018) addresses methods of diminishing bank risks. The research developed by the Sun (2015) addresses the methods and statistical models used in the analysis of the financial-banking system. The study by Norden and van Kampen (2015) describes the dynamics of commercial and banking credit indicators in the financial statements of small and medium-sized enterprises, Ferrando (2015) published some comments on the results of the two researchers. Hernández-Cánovas and Martínez-Solano (2010) study funding at the level of the banking system of Continental Europe. Wehinger (2012) is concerned about the mutations generated by the economic and financial crisis on funding sources. Peicuti (2013) studies securitization in the context of the subprime crisis. Pinto (2014) analyzes the characteristics of securitization on European markets. Pinto and dos Santos (2014) is concerned about the financial instruments that can be used after the 2008 crisis.

Analysis of changes in IFRS 9

The replacement of IAS 39 had three phases, each representing separate chapters in IFRS 9:

a. Phase 1 - classification and valuation of financial assets and financial liabilities - these are classified according to the entity's business model for the management of financial assets and the characteristics of the contractual cash flows of the financial asset;

b. Phase 2 - impairment methodology - takes into account the expected losses;

c. Phase 3 - hedge accounting - there are important changes in how the hedge accounting is presented and evaluated, but for the time being the IASB provides for the possibility for entities to choose to continue applying IAS 39 in the field, or to apply the rules of IFRS 9.

a. Phase 1 - classification and valuation of financial assets and financial liabilities

IFRS 9 uses three approaches to classifying and measuring financial assets:

- amortized cost;
- fair value through other comprehensive income (FVTOI);
- fair value through profit and loss account (FVTPL);

Classification criteria are determined by two factors: business model and SPPI test.

As a financial asset is valued at amortized cost, it must meet cumulatively two conditions:

- the asset is held in a business model whose objective is to invest its assets in order to collect the treasury;
- the contractual terms of the financial asset give rise to certain data to cash flows that only have capital and interest payments related to the amount of principal owed.

When the characteristics of a financial asset contract do not meet the requirement of SPPI - to generate only capital and interest flows, then the asset should be measured at fair value through the profit and loss account.

A financial asset will be measured at fair value through other elements of the comprehensive statement if:

- the asset is held within a business model, the objective of which is to achieve both contractual treasury flows and the sale of financial assets;
- the contractual terms of the financial asset give rise to certain data to cash flows that only have capital and interest payments related to the amount of principal owed.

Fair measurement through the profit and loss account will be made if the assets can not be measured at amortized cost or fair value through other comprehensive income. However, an entity may irrevocably choose to recognize investments in equity instruments that would otherwise be measured at fair value through profit or loss to present the subsequent changes in fair value to other items of comprehensive income. Capital instruments are always measured at fair value and the entity may make an irrevocable choice to present fair value changes in other items of comprehensive income, with the proviso that the instrument is not held for trading.

Under IFRS 9, financial liabilities are measured at amortized cost except:

- financial liabilities that are measured through profit and loss;
- financial debts that occur when a transfer of financial assets does not meet the conditions for recognition;
- financial collateral contracts which are subsequently valued at the highest of the value of the loss adjustment and the amount initially recognized;
- loan commitments at a market rate below the market value and subsequently valued at the higher of the loss adjustment value and the initially recognized value;
- contingent compensation recognized by an acquiring entity in a business combination, which must then be measured at fair value through the income statement.

For comparison, in IAS 39, the classification of financial instruments was based on specific definitions for each category and included: held to maturity, loans and receivables and fair value measurement through the profit and loss account With regard to embedded derivatives, these are not evaluated separately if the host contract is an asset that falls within the scope of IFRS 9. This removes the IAS39 segregated valuation. In accordance with IAS 39, asset / liability that is related to unquoted equity instruments, they should be measured at cost. IFRS 9 eliminates valuation at cost and considers that all derivatives will be valued at FVTPL.

The business model can be seen taking into account:

- management of financial assets and
- the extent to which the cash flows of the portfolio derive from contractual cash flows, from the sale of financial assets or from both.

Specifically, the business model:

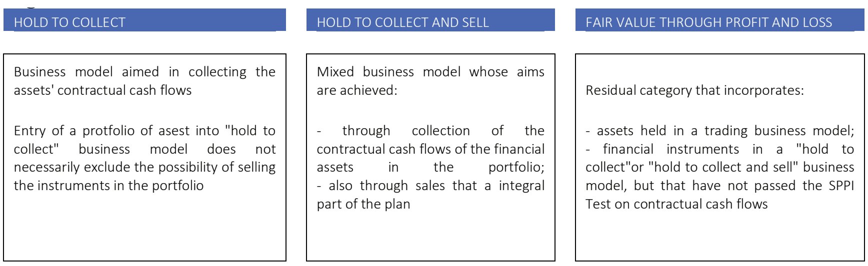
- reflects approaches to managing financial assets to generate cash flows;
- is defined by the superior management of an entity with the proper involvement of business structures;
- it does not depend on the management's intentions for a single financial instrument, but refers to how asset groups are managed to achieve a certain commercial objective;

In accordance with IFRS 9, three business models for financial assets are identified:

- hold to collect - financial assets held to collect the contractual cash flows;
- hold to collect and sell - financial assets held to collect cash flows and sell financial assets;
- others - profit and loss evaluation.

Business Models

Figure 1



Source: ECB

In the "hold to collect" business model, sales analysis is very important: sales need to be analyzed from the point of view of consistency with the business model. The analysis of the consistency between sales dynamics and business model objectives should take into account nature and cause of sales.

Sales are admitted in the following cases:

a. in case of increased credit risk

b. when sales are:

- frequent but insignificant;
- are not common but are significant.

Regarding the frequency of sales it is necessary that it be calculated and monitored periodically by the entity management, and it should be reviewed at least once a year.

To analyze the business model, consider:

- The entity's strategy established through a set of objectives and actions that the entity that owns the financial instrument must do;
- Risks - identifying the risks that determine the performance of the business model and the financial instruments held, especially the approaches with which they are managed and monitored;
- Compensation / KPI - Identify approaches and coherence with clearing methods and KPI (Key Performance Indicator), especially if it depends on the fair value of the instruments held, rather than the margin for collecting the contractual cash flows;
- Reporting - Frequency and characteristics of management information. In this respect, a key role is monitored;
- Frequency of sales - Identify the frequency, value and timing of sales in earlier periods, as well as future sales expectations;
- Reasons for selling the asset - Identifying the reasons behind previous asset cessions and expected sales in the future;
- Expected sales - the probability that sales will be repeated in the future and whether they question the objective of the cash flow business model should be assessed.

The purpose of the SPPI test (principal and interest payments only) is to identify instruments with characteristics different from those of a standard loan agreement that determines the entity to measure them at fair value. In the standard loan contract, the reward for time value of money and credit risk is usually the majority of interest. The time value of money is the interest component that offers reimbursement only with the passage of time and not for other debts and costs associated with holding the financial asset. In order to verify whether a component offers a time-only payment, an entity uses the valuation and accounting of all relevant factors (for example, the currency of the financial asset and the reference period for the interest rate). The change in time of the value of money is analyzed taking into account both quantitative and qualitative factors. Below the correlation between the business model, the SPPI test and the valuation of the financial instruments

Business Models Tests

Figure2

SPPI TEST		Business model		
		HOLD TO COLLECT	HOLD TO COLLECT AND SELL	OTHER TRADING
	Passed	Amortised cost	FVTOCI	FVTPL
	Failed	FVTPL	FVTPL	FVTPL

Source: Author

Comparison table

Figure 3

The impairment methodology requirements for IFRS 9 are significantly different from IFRS 9. IFRS 9 introduces a new model, based on expected losses, which requires early recognition of losses when it is expected to occur in the impairment of quotes. It follows that impairment losses are recorded from the initial recognition of financial instruments and throughout the life of the financial instrument. OBJECTIVES	IAS 39	IFRS 9
During the financial crisis, the delayed discosre of credit losses was identified as a weakness in existing accounting standards	The “incurred loss” model of IAS 39 requires disclosure of losses only on the occurrence of a “trigger event”; as a result, adjustments in the statements were “too little, too late”	The new model proposed by the IASB requires disclosure of losses corresponding to the significant deterioration of credit risk without the occurrence of a tigger event
In order to be forward-looking, the impairment model must incorporate future prospects	Under IAS 39, an entity may only consider the losses deriving from pas events and current conditions	IFRS 9 requires use of a wide set of information, including that concerning future event
The impairment model shall be unique ad valid for all assets	IAS sets out multiple impairment models according to the classification of the financial assets	IFRS 9 establishes a single im;pairment model valid for all fiancial assets not measured at fair value through profit and loss

Source: Author

B. Phase 2 – Impairment methodology

IFRS 9 recognizes the “Expected Loan Loss” (ECL) model for depreciation. Expected credit losses are recognized at each reporting period, even if there are no events that lead to actual loss. In addition, for past events and current conditions, reasonable and probable future information is available which is available without undue cost or effort in determining impairment. IFRS 9 provides that, for impairment purposes, financial assets will be classified in three steps (with a different level of adjustment) depending on the credit risk depreciation at the time of the initial presentation.

- Stage 1 - Expected losses over a 12-month period include financial assets that are not materially impaired, which have a low credit risk;
- Stage 2 - expected lifetime losses - covers financial instruments that have deteriorated significantly in terms of credit quality from initial recognition (unless relevant credit risk has been applied and relevant), but not has objective evidence of a loss event;
- Stage 3 - Expected losses on financial assets for which credit risk increased significantly at reporting date.

Credit losses are defined as the difference between the contractual cash flows and the cash flows that are expected to be received ("cash deficits"). This difference is updated to the effective effective interest rate (or to the effective interest rate adjusted for depreciable credit risk financial assets).

Expected losses over a 12-month period represent a portion of the expected lifetime loss. They are calculated by multiplying the probability of a default in the instrument over the next 12 months by the total amount (lifetime) of the expected loss that would result from this nonpayment.

C. Hedge accounting

IFRS 9 creates a new risk-based hedge accounting model. Reclassification of financial instruments is done if and only if the entity changes its business model for the management of financial instruments. They are not considered changes to the business model:

- changing the intention towards certain financial assets;
- Temporary disappearance is a certain market for financial assets;
- the transfer of financial assets between parts of an entity that have different business models.

Reclassifications of financial instruments are made at each reporting date. Reclassify financial instruments but do not redeem earnings, losses (including gains or losses from impairment) or interest previously recognized.

Impact of IFRS 9 Implementation

Following the analysis conducted at European level implementing January 1, 2018 of IFRS 9, banks have suffered a reasonable erosion of queens. Provisions for anticipated loan losses, rather than already incurred, were the biggest change introduced by the new IFRS 9 International Financial Reporting Standard. Under the rules, banks are required to hold capital against anticipated credit losses for all their assets regardless of their current quality. Still for banks, liquidity does not seem to be a problem, but the concern remains for capital and credit quality. Credit quality, the high rate of non-performing loans affects profitability and capital, reducing the ability of banks to grant new loans. In Romania, according to the data published by the National Bank of Romania, the bad debt ratio in the banking sector declined to S1 / 2018 to 5.71% and is almost four times lower than the peak of 2014.

Evolution of CET1 ratio under IFRS 9

Figure 4

Evolution of CET1 ratio under IFRS 9

Select European banks

Company	Headquarters	Impact of IFRS 9 on CET1 ratio at Jan. 1, 2018 (bps)	Reported fully loaded CET1 ratio (%)	
			FY'17	Q1'18
HSBC Holdings PLC	UK	-10	14.48	NA
BNP Paribas SA	France	-10	11.80	11.61
Deutsche Bank AG	Germany	-13	14.03	13.36
Banco Santander SA	Spain	-23	10.84	11.00
Barclays PLC	UK	-34	13.28	12.24
Société Générale SA	France	-14	11.39	11.18
Lloyds Banking Group PLC	UK	-30	14.06	14.08
ING Groep NV	Netherlands	-20	14.70	14.26
Royal Bank of Scotland Group PLC	UK	+30	15.91	16.44
Intesa Sanpaolo SpA	Italy	-100	14.00	12.24
Banco Bilbao Vizcaya Argentaria SA	Spain	-31	11.08	10.90
Rabobank[1]	Netherlands	-15	15.50	NA
Standard Chartered PLC	UK	-15	13.64	NA
Danske Bank A/S	Denmark	-20	17.53	16.21
Commerzbank AG	Germany	-80	14.06	13.25
ABN AMRO Group NV	Netherlands	-12	17.65	17.52
CaixaBank SA	Spain	-15	11.65	11.57

Data compiled May 23, 2018.
Sample limited to European banks with total assets exceeding €300 billion as of Dec. 31, 2017, and for which IFRS 9 impact information was available.
Data collected on best-efforts basis. Restated data has been used where available for the IFRS 9 impact.
Impact on CET1 ratio is disclosed for fully loaded basis, unless noted otherwise.
[1] Impact on CET1 ratio disclosed is for phased-in basis.
Some impact figures may be approximations, as disclosed by banks.
NA = not available
Source: S&P Global Market Intelligence

Source: SPGlobal.com

Conclusions

IFRS 9 requires major changes in accounting records and in the reporting system, as the methodology for classification and measurement of financial instruments changes, and depreciation implies the identification of losses as of the signing of the contracts. The possible consequences of IFRS 9 include:

- More volatility of the income situation. IFRS 9 raises the risk that more assets are measured at fair value with changes in fair value recognized in profit or loss at the time they arise due to the new valuation methodology of fiancial assets;
- Early recognition of impairment losses on receivables and loans, including trade receivables;
- Entities will need to begin to foresee possible future loan losses in the first reporting period in which a credit is entered - even though the asset is most likely to be fully reimbursed;

- Significant disclosure requirements - they will need new systems and processes to collect the necessary data;
- Defining the business model;
- Reclassification of financial assets between the cascade categories defined in IFRS 9;
- High tax risk as the tax code has not been updated with the new situations identified in IFRS 9, as was the case with the implementation of IFRS on January 1, 2012.

Bibliographical references

1. Ahmed, K., Chalmers, K., & Khlif, H. (2013a). A meta-analysis of IFRS adoption effects. *The International Journal of Accounting, 48*, 173–217;
2. Ahmed, A. S., Neel, M., & Wang, D. (2013b). Does mandatory adoption of IFRS improve accounting quality? Preliminary evidence. *Contemporary Accounting Research, 30*(4), 1344–1372;
3. Anghelache C., Manole A., Anghel M.G., Popovici M., Soare, D.V., Modele de analiza a riscului financiar, ART ECO – revista de studii si cercetari economice, Vol.6/No.3/2015, pg. 55-64;
4. Combes-Thuelin, E., Escaffre, L. (2004). Financial Reporting Practices in the European Banking Sector: Financial Instruments and Fair value, HAL in its series Post-Print;
5. Dumitrescu, D. ,Soare, D.V., New Global Financial Regulatory Framework, Revista Romana de Statistica – Supliment Trim. I/2013, pag. 51-56;
6. IFRS - International Financial Reporting Standards, CECCAR Publishing House, 2016 and English edition 2016;
7. PwC - IFRS 9, Financial instruments, understanding the basics;
8. Order of the National Bank of Romania no. 27/2010 for the approval of the Accounting Regulations in compliance with the International Financial Reporting Standards, applicable to credit institutions, Official Gazette, Part I 890/2010;
9. Instructions of the National Bank of Romania no. 1 / 30.03.2018 regarding the publication quotes regarding the application of the transitional measures for diminishing the impact of the introduction of IFRS 9 on own funds.