IFRS 9 A JEHO VLIV NA FINANČNÍ STABILITU FINANČNÍCH INSTITUCÍ

IFRS 9 AND ITS IMPACT ON THE STABILITY OF FINANCIAL INSTITUTIONS

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ABSTRAKT

Tento příspěvek se zabývá povinnou implementací IFRS 9 – Financial Instrument: Recognition and Measurement, platnou od 1. ledna 2018, která mohla znamenat skokové navýšení opravných položek k pohledávkám bank a tím ohrozit bankovní sector. Toto zvýšení avizovaly předběžné průzkumy nejvýznamnějších čtyř auditorských společností. Cílem tohoto příspěvku bylo provést výzkum z reálných dat prvních možných výsledků a to z mezitímních účetních závěrek bank v průběhu roku 2018. Pomocí statistického Wilcoxonova testu byl vyhodnocen dopad tohoto standardu s cílem zjistit, zda očekávané zvýšení opravných položek zaznamenalo signifikanční změnu. Výsledky testu potvrdily hypotézu, že se nejedná o signifikantní nárůst. Povinná implementace IFRS 9 – Financial Instrument: Recognition and Measurement tedy neznamenala signifikantní změnu v hodnocení bankovních pohledávek a tedy ani ohrožení finanční stability bankovního sektoru. Vedle dopadu nového standardu na stabilitu finančních institucí poskytuje příspěvek i přehled nejzásadnějších změn v oblasti finančních nástrojů.

Klíčová slova: *Finanční nástroje; IAS 32; IAS 39; IFRS 7; IFRS 9.*

JEL klasifikace: M41, M48

ABSTRACT

This paper deals with the mandatory implementation of IFRS 9 – Financial Instruments: Recognition and Measurement, effective as of January 1, 2018, a possible result of which might have been a steep increase in loss allowance on bank receivables that could threaten the banking sector. This increase was reported in preliminary surveys of the top four accounting companies. The aim of this paper was to investigate the first factual data available from the interim financial statements of banks during 2018. Using the Wilcoxon Rank Sum test, the impact of this standard was evaluated to determine whether the expected increase in loss allowance produced a significant change. The test results confirmed the hypothesis that the increase was not significant. Therefore, the mandatory implementation of IFRS 9 – Financial Instrument: Recognition and Measurement did not result in a significant change in the classification of bank receivables and thus did not jeopardize the financial stability of the banking sector. In addition to the impact of the new standard on the stability of financial institutions, this paper also provides an overview of the most fundamental changes in the area of financial instruments.

Key words: *financial instruments; IAS 32; IAS 39; IFRS 7; IFRS 9*

JEL Classification: M41, M48

INTRODUCTION

The aim of this paper is to ascertain whether the implementation of IFRS 9 – Financial Instruments: Recognition and Measurement, mandatory as of January 1, 2018, has resulted in a sharp increase in loss allowance on bank receivables, which could jeopardize the stability of the banking sector. This paper is based around the first available data from interim financial statements, in which banks are required to disclose the impact of the IFRS 9 implementation. In the event of alarming results, the banking sector would have been able to prepare a report to justify this phenomenon and partly mitigate the overall impact.

One of the most recent international accounting standards, IFRS 9 – Financial Instruments, which has been in force since the beginning of 2018, was primarily created as a response to the latest economic crisis. IAS 39 was predicted to be less risky compared to similar issues dealt with by GAAP (Fang, 2018). A large number of unhealthy loans, which banks reported as healthy, are often cited as a possible cause of the economic crisis. The new standard imposes new classification rules on financial assets and liabilities and much higher requirements for loss allowance. IFRS 9 is generally binding for all entities whose accounting is governed by the International Financial Reporting Standards. Banking institutions are the entities most affected by changes brought about by IFRS 9. The core area of impairment should be the most important for banks as they have a number of instruments on the active side of the balance sheet, the main essence of which is the collection of cash flows from them, or their sale. Therefore, these are receivables, both from business relations and, above all, receivables from loans. Loss allowance on bank receivables is expected to increase sharply as of the date when IFRS 9 comes into effect. The aim of this paper is to compare the existing IAS 39 with the new IFRS 9 and to determine whether the implementation of IFRS 9 has had an impact on banks' financial stability. Several researches, in particular the so-called Big Four (Deloitte Global Services Limited, 2016), (EY, 2017), have addressed the above issues. The problem is that these research studies only estimate future research; however, the research presented in this paper is based on existing factual data from the first interim financial statements of banking institutions. This paper examines the hypothesis that the implementation of IFRS 9 did not result in a significant change in the financial assets of banks. The aforementioned data is subjected to a statistical test.

METHODS

To test the hypothesis whether the implementation of IFRS 9 resulted in a significant change in the financial assets of banks, a non-parametric Wilcoxon Rank Sum test was chosen as it was more appropriate than a signed rank test that would only reveal the result we are already aware of, i.e. that the loss allowance did increase. The aim of this paper is not to conclude that there was an increase, but to verify the hypothesis that this increase was statistically significant. The Wilcoxon matched pairs test (Walker, 2013) is based on the calculation of standard deviation and the average of loss allowance differences created under IAS 39 and IFRS 9. If the value of the test criterion exceeds the critical value for this test (Walker, 2013), then a significant change is observed under IAS 39 and IFRS 9. A comparison and analogy method is used to describe the differences between the original IAS 39 and IFRS 9. Within the comparison method, it will be observed how the reporting of financial instruments of banking institutions changes when a given standard is changed.

RESULTS

1.1 COMPARISON OF IAS 39 AND IFRS 9

Now that we are aware of the actual impact of the change of standards on financial instruments, it is advisable to learn what these changes actually are.

Accounting adjustments and financial reporting for financial instruments is such a complex issue that several accounting standards regulate it. They are primarily the following standards (sorted chronologically based on the creation date of the standard): IAS 32 Financial Instruments: Presentation, IAS 39 Financial Instruments: Recognition and Measurement (largely no longer applicable except for hedge accounting rules not covered in this paper), IFRS 7 Financial Instruments: Disclosures and IFRS 9 Financial Instruments. The majority of IAS 39 is no longer in force and has been replaced by the most recent of these, i.e. IFRS 9. IFRS 9 came into effect as of January 1, 2018.

International Accounting Standard 32 (IAS 32) emerged in the 1990s and was first adopted by entities in 1995. Since then, it has undergone many modifications, but the standard is still valid today. It defines the basic concepts relating to financial instruments and is therefore the basis for any later standards that govern this area.

In 2005, the IASB amended IAS 32 and replaced the disclosure provisions of IAS 32 by the new IFRS 7 – Financial Instruments: Disclosures. It entered into force in 2007 and replaced IAS 30 – Disclosures in the Financial Statements of Banks and Similar Financial Institutions. The standard includes rules for the inclusion of information about financial instruments and, in particular, the risks associated with them in the financial statements of an enterprise. In addition, IFRS 7 defines the types of risks that must be reported in financial statements, namely credit risk, liquidity risk, and market risk. The reason for the amendment of the original IAS 39 was, among other things, the criticism the Standard received because of its excessive complexity and for being difficult to implement in practice. In order to understand the new IFRS 9 correctly, it is necessary to summarize the basic principles underlying the original IAS 39.

Categories of financial instruments under IAS 39 were: Financial assets and financial liabilities at fair value through profit or loss (FTPL), Held-to-maturity investments (HTM), Loans and receivables (LR) and Available-for-sale financial assets (AFS) (IFRS Foundation, 2017).

Under IAS 39, financial instruments were initially measured at fair value. However, the related transaction costs were different. If they were measured in the FTPL category, transaction costs were not measured, unlike the other categories. While they were held, the value of the instruments was supposed to be reviewed at least annually. Financial instruments in the FTPL and AFS categories measured at fair value could be impaired or increased (FTPL earnings, AFS capital). Financial instruments in HTM and LR categories measured at amortized cost could only be impaired. Impairment of financial assets is an area that may have undergone perhaps the most significant changes during the revision of international standards and the transition from IAS 39 to IFRS 9. In IAS 39, impairment was carried out based on incurred losses. Expected losses that could occur in the future were not accounted for, although the prospect of a future negative event was very likely. It was only when the entity found objective evidence of impairment that it recorded this impairment in accounting – financial instruments HTM, LR and FTPL as an expense using an allowance account, AFS directly as an equity. Thus, in the event of an asset being impaired, the profit of the financial entity did not decrease and the owners of the company could divide the profit (Ercegovac, 2018).

A full overhaul of IAS 39 had been considered since 2001, when the IASB was established (ASB, 2018) and took over the standard from the former IASC. The new standard was initially supposed to be developed by the IASB together with the US FASB, which develops the US GAAP, with the intention of creating a single document. However, this collaboration was later unsuccessful due to diverging views on some important aspects, and the final version of the new IFRS 9 was issued by the IASB in July 2014. As has already been said, the financial crisis had a significant impact on the creation and the final adoption of the standard, and highlighted the urgent need for new rules and hastened the entire process.

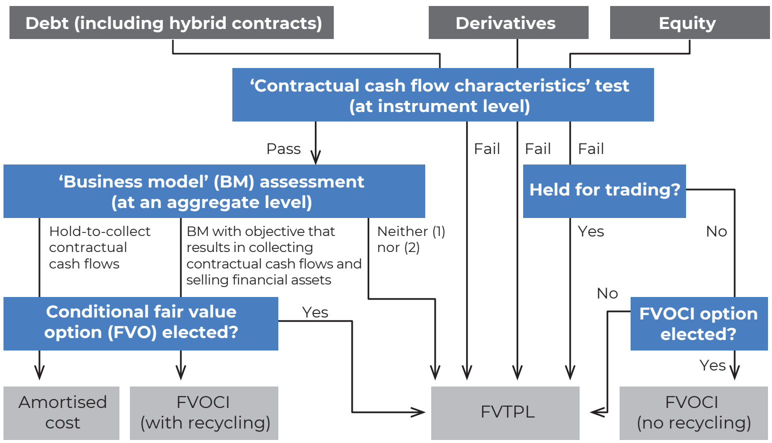
IFRS 9 is effective for annual accounting periods beginning on or after January 1, 2018, if the accounting period does not coincide with the calendar year. Voluntary earlier application of the standard was possible. The new IFRS 9 regulates similar areas as those regulated by the replaced IAS 39. Above all, it governs the categorization of financial instruments and their initial and subsequent measuring and impairment. IFRS 9 also includes significant new hedging requirements. These changes are expected to have the greatest impact on financial institutions' financial reports.

IFRS 9 uses two approaches - Amortized Cost and Fair Value - to measure financial instruments, with Fair Value distinguishing between Fair Value through Profit or Loss (FVTPL) and optional Fair Value through Other Comprehensive Income (FVTOCI) with recycling and no recycling. The preferred approach is the FVTPL category with impact on profit or loss.

In connection with the classification of financial assets, IFRS 9 introduces two new terms - business model and cash flow test. A cash flow test assesses whether the financial asset give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding. A business model refers to how an entity manages its financial assets in order to generate cash flows. IFRS 9 identifies three types of business models: "hold to collect", "hold to collect, and sell" and "other business models" (e.g. held for trading).

In order to determine the appropriate classification category of financial assets under IFRS 9, it is necessary to consider both the business model and the cash flow test, as well as whether the asset is a debt, equity or whether it is a derivative.

Figure 1 » Classification of financial assets under IFRS 9



Source: Aegon Asset, Management Global, 2017

Financial instruments on the liability side are not subject to the same complex classification process as assets. Mostly, financial liabilities are measured at amortized cost, same as financial assets, but an entity can use the classification of liabilities to be remeasured at fair value with an impact on profit or loss. In addition, the standard specifies exceptions where fair value measurement is mandatory, such as the measurement of derivative financial instruments where the entity is in a disadvantageous position. Almost all financial instruments are measured at fair value when recognized, same as in IAS 39. If the fair value of the instrument differs from the price at which the asset acquisition transaction took place, the entity recognizes the resulting difference in profit or loss. If a given instrument is included in the fair value instrument portfolio with an impact on profit or loss, the first fair value measurement is not adjusted for transaction costs, as opposed to other portfolios.

An entity always remeasures financial instruments at least once per accounting period, but measurement that is more frequent is usually required. Remeasuring financial instruments is done in accordance with the rules of the selected portfolio (Fig. 1). Increased attention is paid not only to change in fair value, but also to other changes and related transactions, such as changes in exchange rate differences or interest rates. Instruments measured at amortized cost are recognized through profit or loss in these situations. In the case of instruments in the FFTOCI category, such facts must be separated from the changes caused by the decline or increase in fair value and accounted for in profit or loss as well, while the change in fair value will be reflected in other comprehensive income. For the FTPL category, all changes are recognized through profit and loss.

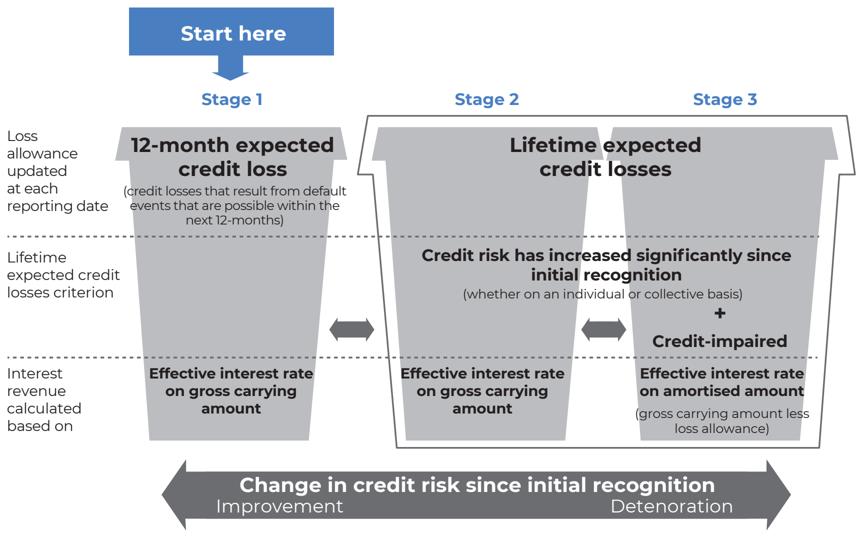
An entity is required under IFRS 9 to recognize an allowance for each financial asset at the amount of the 12-month expected loss or expected loss for the remaining life of the financial asset. In order to determine the approach, it is necessary to distinguish the reason and the concept of loss allowance accounting. For each financial asset, the degree of impairment must be determined, from which the basis for calculating the loss allowance is determined (Figure 2). The classification of receivables is reviewed regularly, always at least as of the balance sheet date.

All assets at the time of recognition, with the exception of purchased or originated credit-impaired financial assets, are classified as Stage 1 until they experience a 'significant deterioration' in credit quality. The amount of recognized loss allowance (or FVOCI capital) is derived from 12-month expected credit losses. Stage 2 is recognized from the moment when the credit risk level has increased significantly, but no demonstrable depreciation has occurred. Full lifetime expected credit losses would be recognized. Stage 3 is most similar to the impairment of financial assets according to IAS 39, as one or more events that have a detrimental impact on the estimated future cash flows of that financial asset have occurred.

It is necessary to use relevant audit evidence available to assess between Stages 1 and 2, which is available without excessive costs and effort. The Standard specifies backstop indicator for credit risk assessment if contractual payments are more than 30 days past due.

In Stage 2, banks also assess loans in which, for example, loan covenant is amended or waived or the debtor's rating has changed. Seventy-two percent of banks consider the threshold for significant deterioration in credit risk to Stage 2 when the loan is 30 days past due. The overdue delay of more than 90 days is considered by the overwhelming majority of banks to be a criterion for classifying a loan as Stage 3. Allowances for purchased or originated credit impaired financial assets are recognized as lifetime expected credit loss.

Figure 2 » Three-step model of financial asset impairment



Source: (EY, 2015)

1.2 OWN RESEARCH

As already mentioned, interim financial statements of banks and financial institutions (in other text marked as "banks") for the first period of 2018 were chosen as the source of data for the statistical test. In those statements, banks reported data on loss allowance as of December 31, 2017, or the balance sheet date (under IAS 39), and as of January 1, 2018, or the date of the first day of the following accounting period (under IFRS 9). However, not all banks have interpreted the data clearly, which is a disadvantage of the somewhat more benevolent reporting methods of international accounting standards. By allowing entities to choose any form of data interpretation, i.e. either as a part of financial statements or anywhere else in its appendixes, the work of an analyst is made more difficult. In some, there is no mention of numerical orders and currencies, which then must be researched further. Three banks made a note of this change not in loss allowance but in assets. However, given the principle of balance-sheet continuity, it can be assumed that these differences were merely differences in loss allowance based on the change of the standard, as another reason for discrepancy should not be possible given the requirement for balance-sheet continuity. However, these banks were excluded from the statistical test, as only the change in total assets (less than 1%) was known, not in loss allowance. After these adjustments, eighteen banking institutions were subjected to statistical testing. Table 1 shows data about the size of the bank, as well as its majority owner. Furthermore, it indicates whether the bank is carrying out accounting according to the Czech legislation or international accounting standards. The obligation to apply IFRS 9 to financial instruments is not limited to banks that carry out accounting according to international standards, but also to banks that carry out accounting according to the Czech legislation. The last column in Table 1 shows whether the given banking institution trades its shares on the Prague Stock Exchange.

Tab. 1 » Overview of information about banking institutions included in this research, Source: modified according to published financial statements

BANK NAME	BANK SIZE	MAJORITY OWNER	LEGISLATION	PRAGUE STOCK EXCHANGE
Banka CREDITAS	Small	Unicapital a .s.	Czech Republic	No
Česká exportní banka	Small	The Czech Republic	IFRS	No
J & T BANKA	Medium	J & T FINANCE GROUP	IFRS	No
Modrá pyramida stavební spořitelna	Small	Societe Generale SA	Czech Republic	No
Air Bank	Small	Home Credit B. V.	IFRS	No
Česká spořitelna	Large	Erste Group Bank AG	IFRS	No
Equa bank	Small	Equa Group Ltd	IFRS	No
Komerční banka	Large	Societe Generale SA	IFRS	No
MONETA Money Bank	Medium	No majority shareholder	IFRS	Yes
PPF banka	Medium	PPF Financial Holdings B. V.	IFRS	No
Sberbank CZ, a. s.	Small	Sberbank Europe AG	IFRS	Yes
UniCredit Bank	Large	UNICREDIT S.p.A.	IFRS	No
Wüstenrot - stavební spořitelna	Small	Wüstenrot & Württembergische AG	IFRS	No
Wüstenrot hypoteční banka	Small	Wüstenrot and Württembergische AG	IFRS	No
Expobank CZ	Small	Igom Kim	Czech Republic	No
OTP Bank	Small	OTP Group	IFRS	Yes
Erste Group Bank	Large	Erste Group Bank AG	IFRS	Yes
Deutsche Bank	Large	Deutsche Bank	IFRS	Yes

Source: Modified according to published financial statements

The source material for the comparison is the content of IAS 39 (IFRS Foundation, 2017) and the new IFRS 9, which is currently only available in its original version (IFRS Foundation, 2019).

The input data and results of the Wilcoxon matched pairs test are shown in Table 2. The column "Increase of loss allowance" shows the relative volatility of loss allowance ranging from 2% (Czech Export Bank) to 36% (Sberbank CZ, a. s.). However, the statistical test revealed that the increase was not significant. The hypothesis was thus confirmed. The test criterion value of 0.09 did not exceed the critical value of 1.75. In general, the banking sector did not see any significant increase in loss allowance on receivables arising mainly from loans.

Tab. 2» Input data and Wilcoxon matched pairs test results, Source: compiled from the financial statements of banking institution

BANK NAME	ALLOWANCES IN MIL. CZK	ALLOWANCES IN MIL. CZK	LEGISLATION	PRAGUE STOCK EXCHANGE
	IAS 39 DECEMBER 31, 2017	IFRS 9 JANUARY 1, 2018		
Banka CREDITAS	198	251	53	27%
Česká exportní banka	6,627	6,759	132	2%
J & T BANKA	2,219	2,773	554	25%
Modrá pyramida stavební spořitelna	687	845	158	23%
Air Bank	696	883	187	27%
Česká spořitelna	1,082	1,233	151	14%
Equa bank	384	433	49	13%
Komerční banka	11,959	13,154	1,195	10%
MONETA Money Bank	12,757	13,592	835	7%
PPF bank	1,067	1,269	202	19%
Sberbank CZ	1,195	1,625	430	36%
UniCredit Bank	7,709	7,940	231	3%

Source: Compiled from the financial statements of banking institution
Continues on the page 34

Tab. 2» Input data and Wilcoxon matched pairs test results, Source: compiled from the financial statements of banking institution

BANK NAME	ALLOWANCES IN MIL. CZK	ALLOWANCES IN MIL. CZK	LEGISLATION	PRAGUE STOCK EXCHANGE
	IAS 39	IFRS 9		
	DECEMBER 31, 2017	JANUARY 1, 2018		
Wüstenrot - stavební spořitelna	813	991	178	22%
Wüstenrot hypoteční banka	387	414	27	7%
Expobank CZ	238	309	71	30%
OTP Bank	1,939	2,238	299	15%
Erste Group Bank	110,874	115,762	4,888	4%
Deutsche Bank	108,225	125,898	17,673	16%
Median	14,947	16,465	x	x
Standard deviation	33,671	37,162	x	x

Source: Compiled from the financial statements of banking institution
Continues from the page 33

DISCUSSION

The dreaded transition to IFRS 9 due to the steep increase in loss allowance on bank receivables that could threaten the stability of the banking sector was not confirmed.

IAS 39 was often criticized for its lack of clarity and for being difficult to implement in practice. In this way, IFRS 9 logically seeks to come up with simpler rules that are easier for businesses to understand, more uniform, and with fewer exceptions. Areas that have undergone only minor adjustments are the initial recognition and disposal of financial instruments.

During initial recognition, both standards try initially to measure the asset at fair value. IAS 39 is strict in this respect, but in some cases, IFRS respects the transaction price, such as in the case of trade receivables that contain only a negligible financial component. Particularly in this case, however, it is unclear whether the rules are actually being simplified, since the assessment of whether a given financial component is insignificant or not is governed by another standard, namely the IFRS 15 – Revenue from Contracts with Customers.

The process of categorizing financial instruments has changed significantly with the IFRS 9. While, in accordance with IAS 39, the instrument was classified in a category that then determined the measuring method of the instrument, IFRS 9 first determines how the instrument should be measured, which then determines how the instrument should be classified. It is clear that some entities are more affected by the new standard than others; however, the process of reclassifying their financial instruments is mandatory.

Generally, IFRS 9 favours for instruments to be measured at fair value with changes being recognized in profit and loss. On the one hand, the rules can simplify and unify measuring methods for entities, as each instrument can be measured at FVPL; however on the other hand, this model will result in an added threat of volatility in profit and loss, as well as reporting unrealized profits with the risk of distributing it to owners.

The area of impairments was one of the most criticized issues in relation to IAS 39. The reason for this was the very model that the impairment or credit losses were only recognized when there was objective evidence of a credit loss event ("incurred loss model"). This model proved inefficient, as it did not allow the entity to create a sufficient financial buffer to cover future losses in the event of adverse developments. Late recognition of credit losses was, as has been said, a major problem during the financial crisis.

Another problem of the now former standard was the significant inconsistency and complexity of reflecting the impairment of the asset in accounting, as different approach was applied to each financial instrument category.

The new IFRS 9 brings a completely new perspective on the issue of instrument impairment, when the impairment of a financial instrument is not accounted for ex post, but during initial recognition or when credit risk increases – the expected credit losses model. Under IFRS 9, impairment is applied to all types of financial instruments other than FVTPL, as the fair value itself already contains possible impairment.

Before the standard came into effect, banks had to deal with a number of obligations to ensure a smooth transition to the new rules. One of the biggest challenges was certainly the development of new statistical models, possibly adjusting the parameters of existing models, and developing IT systems to determine expected losses. Furthermore, it was necessary to create a system architecture for collecting the necessary data and systems for the calculation of the increase in credit risk for individual assets. According to a survey by Deloitte, this challenge was one of the most feared during the transition to IFRS 9 (Deloitte Global Services Limited, 2016).

Although the new standard should ideally not affect the provided products, some banks believe that the implementation of IFRS 9 will indirectly affect the loan allocation conditions and pricing policies, including interest rate increases for new loans and, overall, may change the bank's business model. In many cases, banks also had to make personnel changes; more precisely strengthen both accounting departments and risk management teams (EY, 2017). On the other hand, the standard also gives entities the opportunity to use several concessions to make the transition less burdensome. One such concession is, for example, waiving the obligation to report comparative information for previous years in the first reporting period in which the entity complies with the new standard.

Nevertheless, the implementation of the new standard is a major challenge for banks and we can expect that the implementation of some of the lower priority areas of the standard, such as back testing, will be delayed and will be completed in 2018 or later. The implementation process of any new regulation is demanding not only from a technical point of view, but also from a financial perspective (Deloitte Global Services Limited, 2016).

CONCLUSION

The issue of impairment of financial assets has undergone significant changes and an almost complete overhaul compared to IAS 39. At first glance, the most significant change is the actual moment of the impairment, which, in accordance with the new standard, occurs at the time of the initial recognition of the asset and subsequently whenever there is a significant deterioration in credit risk. Therefore, the expected loss approach is applied when the losses taken into account have not actually been realized yet. The original model in IAS 39 resulted in credit losses being recognized only after a credit loss event occurred. As a result, loss allowance was often insufficient and late. The new concept will enable financial entities to create loss allowance in an appropriate amount and thus ensure a sufficiently large financial buffer in the case of potential adverse developments in the economic situation.

In a period of stagnant or declining economic performance, banks will not be forced to reduce the availability of loans significantly, thereby preventing an even greater recession. Loss allowance created at a sufficient level will help absorb economic shocks, cover potential losses actually incurred, and thereby avoid an insolvency of financial institutions.

The actual implementation of IFRS 9 did not pose a threat to the financial stability of the banking sector.

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