Effect of Implementation of IFRS 9 Provision Systems in GCC Countries: A Case Study using Data from Oman

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Mohammed Azizur Rahman Shuman
Sohar International Bank SAOG, Sultanate of Oman
(mohammed.shuman@soharinternational.com)

Mohammad Arman
North South University, Dhaka
(mohammad.arman@northsouth.edu)

IFRS 9, the replacement of IAS 39 was issued by IASB in 2014 and became mandatory in 2018. Impairments of financial asset are based on Expected Credit Losses rather than Incurred Credit Losses. This is expected to increase loss provisions and Common Equity Tier 1 while total capital ratio decreases. In this study, effects of this transition particularly in the Oman banking industry are analyzed. The paper also shed light on the first year effect of the IFRS 9 adoption on provisions and regulatory capital. There are still certain issues and aspects that make comparisons among banks challenging.

Keywords: IFRS9, Expected Credit Losses (ECL), IAS39, Loss Provisions

1. Introduction

With an intention to combat any upcoming financial crises, G-20 advised accounting standard setters to change the model for estimation of credit losses (or "provisions"). As a result, it was felt necessary to replace the "incurred loss" model with the "expected loss" model to ensure timely and adequate estimation of credit losses. IFRS 9 redefines the way how a business entity defines business models, to classify and measure financial instruments, i.e. financial assets, financial liabilities, and some contracts to buy or sell non-financial items. IFRS 9 is made effective for annual periods beginning on or after 1 January 2018. On the contrary of IAS39, which is a standard based accounting standard, IFRS9 is a principal based standard.

IFRS9 is one of the major changes in accounting standards since 2018 and perhaps the most visible one in terms of the standard itself and impact thereof. It was expected to have a substantial impact on the financial performance and financial position. It also was predicted that the new standard shall have both short term and long term impact on the capital adequacy and overall stability on the individual banks and ultimately on the banking sector.

IFRS 9 requires an entity to recognize a financial instrument as soon as it becomes a party to the contractual provisions of the instrument. At initial recognition, a financial asset or liability is measured at its fair value. In principle, IFRS 9 introduces an expected credit loss (ECL) model, which uses a dual measurement approach. For performing assets which is not impaired or does not suffer from a significant increase of credit risk (SICR), a 12-month ECL approach is used while lifetime ECLs, being applicable for the financial instruments carries symptoms of a significant increase in credit risk (SICR) since initial recognition and financial instruments which are already impaired. This model relies on banks' detailed and behavior-based estimates of ECLs and establishing when a situation of SICR occurs from ignition recognition and also successive testing. The assessment of ECL is rather a living process that takes care of a lot of external information on the counterparty such as ratings, credit spreads and predictions about future conditions.

IFRS 9 also allows a bank to switch to a new risk based hedge accounting model including new hedging strategies. IFRS9 is more principles-based while IAS 39 had been mostly using a judgmental approach in the assessment of qualifying, rebalancing and discontinuing hedge accounting (KPMG, 2016).

ECL model was expected to achieve the goal of getting a forward looking impairment as IFRS9 requires credit losses to be recognized from the origination of the transaction and the level of provisions to be increased when the credit quality of the transaction worsens but it has not defaulted. After implementation of ECL models in the provisioning system, it was expected that the gap between expected loss and actual loss would narrow down.

2. Literature Survey

Sufficient time has not been passed since the implementation of IFRS9 (reporting started since 2018). Adequate time series data is not available to conduct impact studies. Few studies have been completed predicting the impact from the theoretical perspective, while few studies cover 1-year's impact as well. The very primary impact of the implementation of IFRS9 among the listed commercial banks of GCC countries was studied (KPMG, 2018). It was observed that, on the date of the initial application (i.e. January 01, 2018), the base of the provision was increased by 30.2 percent in IFRS 9 compared to IAS 39. Out of the total exposure of financial instruments subject to ECL computations, 7.9 percent was placed in stage 2. 9.7 percent of total assets were measured at fair value upon transition to IFRS 9. In the initial year of implementation, the CET1 impact was observed of 90 bps (approx.) from 16.0 percent to 15.1 percent on recognition of ECL under IFRS9. It was also observed that net impairment charges on loans gone down by 15.1 percent to US$1.5 billion from Q1 of 2017 to Q1 of 2018.

HSBC adopted the principles of IFRS 9 on January, 2017 with the exception of the provisions relating to the presentation of gains and losses on financial liabilities designated at fair value and measured the impact at the end of 2017 on consolidated level. They observed a decrease net assets of $1,004m (a decrease of $2,232m from additional impairment allowances and an increase of $908m from the measurement of financial assets and liabilities) and an increase in net deferred tax assets of $320m.

Sultanoğlu (2018) expected that, ECL application by European banks would result in on average 13%-18% increase in loss provisions and Common Equity Tier 1 (CET1) and total capital ratio decreased by on average 45-75 basis points (bps) and 35-50 bps, respectively whereas the total amount of provisions will be diminishing by 4.1% and will have 33 bps and 21 bps positive impacts on CET1 and total capital adequacy ratio on average, respectively for Turkish banks.

The Impact of IFRS 9 (Increase in Credit Risk Provisioning) on Banks' Regulatory Capital was studied (Petra, 2018). It was observed that institutions using the Internal Rating Based (IRB) model approach usually suffers from lower deterioration in the capital ratio (capital realignment) in comparison to banks using the Standardized Approach (SA).

The scant data available so far seem to confirm these conceptual insights (Sanchidrián and García, 2018) in the introduction section. Some criticisms of the ECL model allude to its pro-cyclicality, requirement of customized provisioning model for each financial institution leaving a scope of manipulation, absence of yardstick to compare member financial institutions of the same economy, complicacy of the model techniques and model dynamics, etc. The ECL model also allows for greater subjectivity in its application, which must be guided by the regulator to anticipate more accurately in future credit losses, not leaving room for earnings manipulations.

In the public domain there is no research available to compare the results of provision numbers (base of provision and **required provision) for both the methods: IAS 39 and IFRS9.A true comparison of the both would help in determining the** adequacy and appropriateness of implementation of IFRS provisioning system in the banking sector. Primarily, Oman baking sector was selected as there are few licensed banks operating in Oman and number of listed banks are even less. Additionally, banks operating in Oman is almost homogeneous in nature.

3. Research Methodologies

The empirical research consists of two parts. First, provisioning number was computed and compared for two processes: (a) as per existing guidelines for loan classification of Central Bank of Oman (CBO) and (b) as per methods developed on the principles of IFRS 9. Secondly, the impact of the provision on the capital parameters was tested using a t-test applicable for paired two samples' means.

The study followed the following range of definitions of terms while collecting, classifying, testing, and interpreting the data. Followed are definitions adopted from the Central Bank of Oman (CBO) guideline for definitions of loan classification. Excerpts of definitions of various classified account namely Special Mention (SM), Sub-standard (SS), Doubtful (DF) and Loss (BL) as detailed in CBO circular # BM 977 are summarized below:

- **Special Mention (SM)**: Special Mention loans are characterized by potential weaknesses that calls for preemptive actions of loan management. Predominant characteristics of Special Mention loans includes (a) cash flow// liquidity issues (b) Inadequate, inappropriate or unreliable financial information and/or statements (c) loss of value of and/or control on collateral (d) the quality and condition of collateral (e) frequent changes in senior management (e) inadequate documentation and non-cooperation in continuing documentation (f) business slowdown issue and inadequate capacity of credit servicing (g) improper and inappropriate intra-group transfer (h) related party transactions (i) enhanced economic volatility and deteriorated market environment which may invite business (j) poor performance in the related industry (k) significant litigation against the borrower with potential significant financial impact, and (l) 60 to 89 days past due of any contracts or the whole loan of the client
- **Substandard (SS)**: Substandard loans are characterized by well-defined credit weaknesses demonstrating that timely repayment of the obligations is in jeopardy. These loans signals distinct possibility that the bank shall experience some loss it the deficiencies continued. Loans suffering from any of the characteristics namely (a) cash flow/documentation inadequacy (b) inadequacy in business operations or bank accounts(c) Forthcoming foreclosure or acquisition of collateral (d) fail to repay short term commitments on time (e) repetitive rollovers/renewals without defined source available, (f) clearing delinquent loans by creating new loans/disbursements in own/related names, (g) significant deterioration of financial statements in terms of solvency, liquidity or profitability (h) disputed loans and (g) past due between 90 to 270 days in any contracts or the whole loan are classified as Substandard.
- **Doubtful (DF)**: Doubtful loans are loans that exhibit single or multiple weaknesses mentioned in substandard category and have enhanced symptoms of default covering (a) a incurred loss exposure beyond prevailing circumstances and conditions (b) enhanced level of weaknesses affecting collection or liquidation (c) conditions enabled legal action (d) past due for 270 to 630 days in any contract or the whole loan.
- **Loss (BL)**: Loss loans are loans that are already considered uncollectible at least from reliability perspective, requiring full provision which includes any of characteristic including (a) severe delinquency (b) absconding/insolvent borrower coupled with nil collaterals (c) valuation issue of collateral (d) no hopes of collection, (e) past due for 630 days or more for any contracts or the whole loan.
- **Non-Performing Loans**: Credits classified under Substandard, Doubtful and Loss categories are Non-Performing Loans (NPLs).

In contrast to the definitions provided above, IFRS guidelines (CBO circular No 1149 dated 13.04.2017) suggested the following set of definitions:

Stage 2 Assets or Loans with SICR: IFRS9 vide paragraph B 5.5.17 provides a non-exhaustive list of information that is relevant to assessing changes in the credit risk. Banks are expected to consider the same while building their own ECL model. In addition to that banks should check Corporate borrowers with exposure Omani Rial 0.5million or more, for concurrence of any one or more of the events as evidence of SICR including (a) Inadequate, unreliable or unavailability of financial, (b) Non-cooperation by the borrower on documentation requirements (c) Borrower is in the process of litigation with significant financial impact, (d) frequent change in senior management (e) Intragroup inappropriate fund transfers (f) Deferment/delay in commercial operation beyond a year, (g) borrower is approved concessions in terms compared to original approval (including extension of moratorium, restructuring, deferment of payment, waiver of covenants, etc), (h) 25%+ fall in the turnover or earnings before interest and taxes (EBIT) as compared to the previous year (i) 20%+ erosion of net worth compared to the previous year-end with an increase of leverage (j) debt service coverage ratio (DSCR) reduced to less than one.

Stage 3 (Credit-Impaired) Assets/Loans: Definition of Stage 3 is left in the discretion of individual bank in line with the principal, sense, and sentiment of IFRS9. The floor of Stage 3 classification is defined as (a) 90 days past due (DPD) on any material credit obligation (5% of total exposure) with the Bank (b) Cross product default.
Besides, banks are also encouraged to add more objective as well as subjective criteria to ascertain the eligibility of placing the instrument under Stage 2 and Stage 3. An exhibit comparing the provisioning criteria is mentioned below.

Exhibit 1 *Comparison of Default Definitions*

Objective Criteria						
Days Past Due	0-30	31-59	60-79	80-179	180-269	270-360
CBO Guidelines	Standard	Standard	Special Mention	Substandard	Doubtful	Bad
Additional **Subjective Consideration**			*Yes, as above*	*Yes, as above*	*Yes, as above*	*Yes, as above*
IFRS Guideline	Stage 1	Stage 2		Stage 3		
Additional **Subjective Consideration**		*Yes, as above*		*Yes, as above*		

Note: Excludes cases where restructured loans, which is assessed and reported separately, which is also, subject to special guideline of central bank.

4. Data and Data Sources

From the literature discussed above, it can be logically expected that implementation of IFRS9 causes an increase in provision base (i.e. gross of non-performing asset and stressed asset) and computed provision thereof. This study compares and analyzes the difference in provision numbers computed by two methodologies: CBO method and IFRS9 method. This study depends on secondary data sources. Public banks under supervision of Central Bank of Oman (CBO) who are listed with Muscat Securities Market (MSM) were considered as samples for the study. Information on net asset size, asset classification and provisions for each classification segment and capital components were considered as variables of interest. IFRS was implemented in Oman along with the other member countries of gulf on January 01, 2018 after which first quarterly results were published on March 31, 2018. Quarterly data for 6 quarters (Q1/2018 through Q2/2019) was taken under consideration. For seven banks and six quarters total sample should be forty two, which came down to thirty due to data insufficiency of two quarters of a Bank. A sample size over thirty satisfies the minimum requirement of normal distribution.

5. Empirical Result

Based on the tests, the result could be discussed in light of standard asset ratio, non-performing (i.e., impaired) asset ratio, and total provision ratio.
Standard Asset Ratio: As per CBO guidelines, both standard and special mention (60-89 DPD) assets are classified as performing loans (standard assets), while as per IFRS assets classified in Stage 1 and Stage 2 are performing loans (standard assets). It is worth mentioning here that critically special mention assets are carries higher chances of probabilities of default (CBO guideline), while stage 2 assets (as per IFRS9 guideline) suffer from significant increase in credit risk (SICR).For the sake of comparison among both of the guidelines, the definitions are aligned in the following way.

Table I *Comparison of Asset Ratio that Does Not Suffer from SICR or Impairment - All Financial Assets*

	Max	**Min**	**Average**	**Count**
As per CBO classification guidelines				
Performing assets = Standard Asset/Total Assets	0.98	0.87	0.94	40
Non-Performing Asset = 1- Standard Asset	0.13	0.02	0.06	40
As per IFRS 9 guidelines				
Performing Asset: Stage 1/ Total Assets	0.94	0.68	0.82	40
Non-performing asset: (Stage 2+Stage3)/Total Assets	0.32	0.06	0.18	40

T-Test for Paired Two Sample for Means were conducted for the sample on standard asset ratio which generated a t-stat of 10.49 against critical t value (two tail) of 2.02 (99.99% CI; p value is also much lower than 0.05). Hence, it can be inferred that the means are significantly different.

Non-Performing Asset Ratio: As per CBO guidelines, both Substandard, Doubtful and Loss categories are considered as non-performing loans (defaulted assets), while as per IFRS assets classified in Stage 3 are credit impaired assets (defaulted assets). Theoretically, Stage 3 assets (as per IFRS9) are supposed to be much higher than classified assets (CBO definition). The following Tables shows the descriptive statistics for NAP ration of the sample under study.

Table II *Comparison of NPA - Credit Assets Only*

	Max	Min	Average	Count
CBO NPL Ratio	0.05	0.00	0.03	40
IFRS Stage 3 Ratio	0.05	0.01	0.03	40

T-test for Paired Two Sample for Means were conducted for the sample on NPA ratio which generated a t stat of (2.04) against critical t value (two tail) of 2.02 (95.2% CI; p value = 0.048). Hence, it can be inferred that the means are marginally different at a statistically significant level.

Though coverage stage 3 assets are more than NPA assets (aggregate of assets classified as substandard, doubtful and bad), it is observed that means of both are marginally different. This number implies that still there still scopes to implement the core concept of IFRS 9 standards in among the banks. It also reveals the fact that stage 3 assets still covers the CBO defined NPA (aggregate of assets classified as substandard, doubtful and bad, DPD basis only), which is the primary coverage. If the true sense of IFRS9 standards were applied, stage 3assets would exceed NPA.

Total Provision Ratio: Table III shows the result from comparison of total provision ratios. t-Test for Paired Two Sample for Means were conducted for the sample on Total Provisions Ratio which generated a t stat of -2.00 against critical t value (two tail) of 2.02 (94.8% CI; p value = 0.052). Hence, it can be inferred that at 95%CI, there is no significant difference between means of total provisions following the two guidelines. However, as the value suggests the difference or, lack of it is not quite significant.

Table III *Comparison of Total Provision Ratio - Loans Only*

	Max	Min	Average	Average Increase	Average Decrease	Count Increase	Count Decrease
Provision Ratio (CBO guidelines)	0.043	0.014	0.027	0.027	-	40	0
Provision Ratio (IFRS guidelines)	0.050	0.012	0.028	0.028	-	40	0
Increase in provision*	0.486	(0.151)	0.179	0.285	(0.069)	28	12

Note: *Increase in provision = (Provision as per IFRS9 guideline - Provision CBO based)/Provision (CBO based)

6. Discussion

The means of **Standard Asset Ratio** by two definitions differs significantly and substantially (t stat of 10.49 against critical t value, two tail, of 2.02, 95% CI). It is due to the fact that impairment calculator starts from DPD 30 in IFRS9, which was DPD 60 as per the CBO guideline, leaving a lower amount of performing assets (stage 1 as per IFRS9) compared to IAS39. It was expected that this reduced asset base for standard assets (performing assets) as per IFRS9 would decrease general provision and increase specific provision.

The means of **Non-Performing (or Impaired) Asset Ratio** by two definitions differs marginally (t stat of 2.04 against critical t value, two tail, of 2.02, 95% CI). No substantial change has been observed. Hence, it may be inferred that both of the incurred-loss model and expected-loss model is yielding provision ratio, the differenced of which is still narrow, which might be non-intentional call as well. So, primarily it is seen that expectations are not met. It might also be resulting from bank's intention not to increase provision base. Last but not the least is the reason that models are not designed appropriately. As per definition, Stage 3 of IFRS9 should be higher than IAS 39 defined NPA. In case this insignificant difference prevails, regulator might need to advise minimum criteria of Stage 3 which further should be supervised by on site or off site reports/inspections.

The means of **Total Provision Ratio** by two definitions does not differ significantly (t stat of 2.00 against critical t value, two tail, of 2.02, 95% CI), though the process and methodology differs significantly. No substantial change has been observed. Hence, it may be inferred that, financial institutions are reluctant to provide additional provision for enhanced coverage of risk identified. This financial behavior may be considered subversive to the sense and sentiment of principal based system.

7. Conclusion

Transitional arrangements are beneficial for both SA (incurred loss model) and F-IRB (IFRS9-expected loss model) method as far as relieving provision base. Moreover, the main reason is the supervisors' lack of uniform definition asset classification and implementation of the same. Apparently, IFRS 9 transitional arrangements introduced higher volatility and realignment of provision base. There is an essential threat of ununiformed implementation across financial institutions. On the top, a guideline might be necessary to ascertain floor level values of key variables of IFRS9 provisioning system including probability of default (PD) and loss given default (LGD). The same shall enhance market discipline.

Besides designing the new floors of key parameters and adopting stringent policy for asset classification, rigorous on-site and off-site supervision is also necessary for adequate implementation of the standard for combating potential financial crisis in the long run for a sustainable development by using the ECL methodologies as an essential tool to achieve the objectives of all stakeholders.

Primarily this study is focused on determining the significance of differences between incurred-credit-loss models with expected-credit-loss model. Further study is necessary to determine the root cause of provisioning numbers from model perspective and implementation perspective. The coverage area might be increased to member countries of Gulf Co-operation Council, as they possess the similar financial culture.

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