ApexAfrica CAPITAL LTD
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" IFRS 9 Revolution"

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Given the onset of IFRS 9 as from 1st Jan 2018, we seek to enlighten you on the standard and its impact on banks. The IFRS revolution kicked in on account of the global financial crisis of 2008, with the conviction that accounting rules contributed to the escalation of the economic crisis. The standard was issued by the International Accounting Standards Board (IASB), the main institution responsible for international accounting standards .

In Kenya, banks intend to roll out implementation of the standard immediately even as the regulator accorded them an additional five years to grow their capital balances, in the event that their capital bases go below the required capital adequacy levels set out by the regulator. Gloom on the standard for investors is on how implementation will impact their banking portfolios, as it is expected that higher provisions will affect profitability impacting investor returns. In this feature, we seek to shed a light on how banks will make additional provisions and the effects on their financial statements.

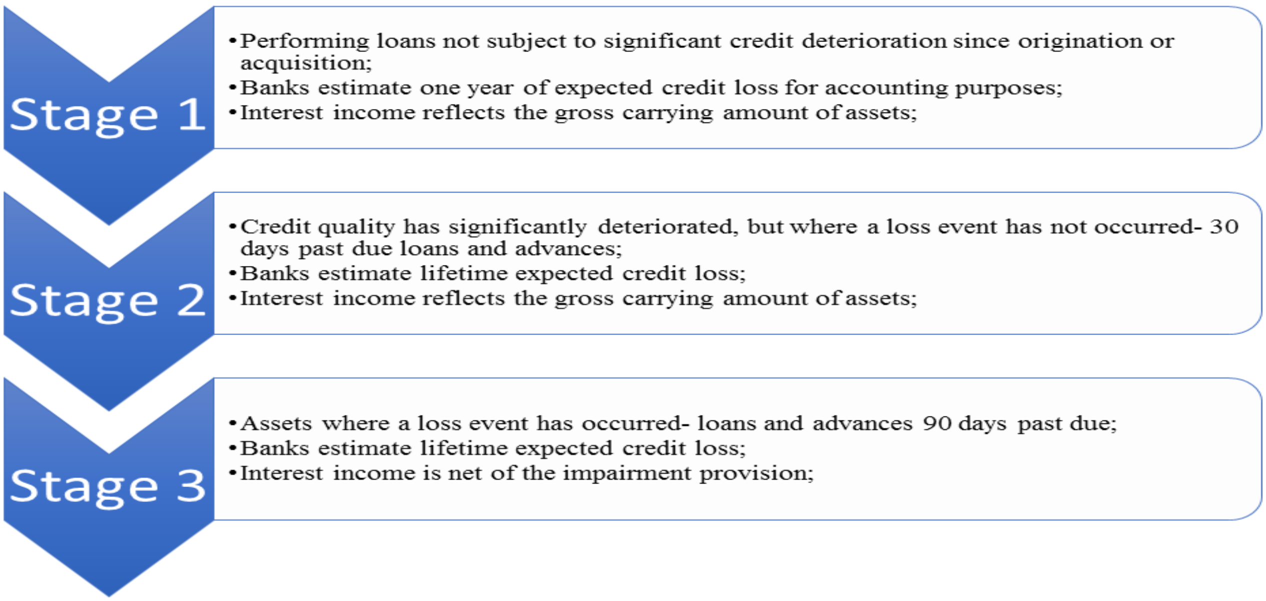
Measurements of Financial Assets

IFRS 9 provides guidelines for accounting for financial instruments requiring recognition of a financial asset/ liability as the contractual provisions fall due. Under IFRS 9, financial assets /liabilities are measured by-:

- **Amortized cost** - for assets held to collect contractual cashflows on specified dates as payments of principal and interest on the principal amount outstanding. This is the measurement for loans and advances.
- **Fair value through other comprehensive income**- purpose of the asset is to collect contractual cashflows and sell the financial asset in the future.
- **Fair value through profit or loss** - for assets not valued using the above methods.

Impairment and Loss Stages

Given that banks have to make credit impairment provisions, IFRS 9 guideline is that impairments will be recognized earlier under an expected loss model as opposed to an incurred loss model that was in use before (IAS39). Sound complex? See how loans and advances will be provided for at each stage:



Impairment Calculation

The factors to consider in impairment loss calculation are:

- Probability of Default (PD)
- Loss Given Default (LGD)
- Exposure at Default (EAD)

Consequences Of Implementation

Impact on regulatory capital:

Banks preserve a basic level of capital adequacy to cater for dividend payment to shareholders and avoid taking capital actions such as raising equity, deleveraging their balance sheet or transitioning to less risky and profitable activities. Additional impairment acts as a drag on capital resources. Over time, due to additional provisions that eat into the capital for banks, smaller banks may be forced to consolidate to raise capital adequacy to the required levels.

Impact on stress testing and capital buffers

Due to an increase in level of impairment and volatility in loss allowances, stress testing will prove to be more challenging with these increases driving up capital buffers. Banks will be forced to conduct scenario analysis on business models and make alterations to reflect economic and credit changes. In effect this should lead to better allocation of capital.

Impact on credit appraisal

Banks will be expected to tighten their credit appraisal processes to avoid losses from non-performing loans.

With these impacts, banks will consider the following when lending-:

- Duration– longer period loans have a higher probability of default.
- Collateral- Unsecured exposures will have a greater provision for impairment
- Counterparty ratings– heavier provisions on higher risk clients who will be penalized higher by IFRS 9, for example clients categorized as 'risky' by credit rating agencies such as Metropol, TransUnion.
- Business sectors– given that economic changes will affect business models, banks will be more cautious in lending to business sectors with greater sensitivity to economic cycles.

IFRS 9 Benefits

Its not all dull and dreary with IFRS 9. Positive impact from additional disclosures includes-:

i. Decreased cost and speed of information dissemination due to better transparency to investors, the public and other stakeholders. Decrease in cost of private information will reduce movement and increase stock price informativeness.

ii. Sound documentation of internal credit risk management policies and procedures, saving investors the worry that their funds are at risk especially with the collapse of some financial institutions witnessed in the country in the past few years.

Given that banks have been struggling with non-performing loans for some time now, IFRS 9 just comes in at the right time. We expect to see a decrease in NPLs as banks implement stringent credit procedures over time. However in the near term, we anticipate that profits will dip as increased provisioning will dent the bottom-line. Additional capital requirements to cover for increased impairments may lead to mergers between small banks as they seek to meet capital adequacy.

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