Cytonn INVESTMENTS

The IFRS 9 Transition: A Road to Vigilance?

The IFRS 9 Transition: A Road to Vigilance?

The International Accounting Standards Board (IASB) published the final version of the IFRS 9 – Financial Instruments on 24th July 2014, which replaces IAS 39 – Financial Instruments: Recognition and Measurement (which received criticism for capturing credit losses on loans too late in the credit cycle), and is mandatory for periods beginning on or after 1st January 2018, with early adoption permitted. IFRS 9 was developed in three phases, incorporating three fundamental changes, namely (i) the classification and measurement of financial assets, (ii) impairment treatment, and (iii) hedge accounting. Of the three key changes, the impairment of financial assets is expected to have the biggest impact on the banking sector. IFRS 9 will take on a forward looking impairment model, with banks providing for expected losses at the inception of loan disbursement, while the lenders will be required to calculate unrealized default on a facility, depending on the stage of the financial instrument, except in the case of purchased credit-impaired financial assets, where expected credit losses are factored into the effective interest rate.

Different stakeholders in the Kenyan Banking Industry, ranging from the Central Bank (CBK) to the Institute of Certified Public Accountants of Kenya (ICPAK) have had their fair share of input on the implementation of IFRS 9. ICPAK noted that it was looking into the implementation of IFRS 9, streamlining the process to avoid discrepancies in application between distinct banks, while also ensuring full disclosure. Recently, the Central Bank released draft guidelines seeking to create a framework that will allow banks a five-year period to factor in the impact of additional provisions on the banks' financial performance, occasioned by the adoption of the new accounting standard, IFRS 9. Additionally, the regulator proposes that the provisions arising from CBK prudential guidelines which are above and beyond the IFRS 9 requirements be charged on capital as opposed to income, while also requiring banks to disclose their capital ratios in published results, both before and after the additional expected credit loss provisions have been added back. This will come as a sigh of relief, especially to the smaller banks in the industry, who might have been forced to seek additional capital from shareholders or risk playing in the bad books of the regulator, as it was expected that the bigger banks would be able to cushion the effects of reduced capital due to adequate capital buffers.

With the implementation of IFRS 9, we have carried out a brief survey of the Kenyan Banking industry, and the consensus estimate of an increase in Non-Performing Loans is at 30.0%, an estimate also supported by Ernst and Young (EY) European IFRS Banking Conference. However, it is expected that banks will pass this effect on to the balance sheet, which will first reduce the statutory reserve item in the balance sheet before affecting the retained earnings, and hence, a reduction in Tier I capital, which would probably see some banks operate below the regulatory minimum requirements. Having received some insights into the extent of the impact of IFRS 9 on capital ratios from a few industry players and stakeholders, we have been able to estimate the expected impact on the capital ratios and buffers for each of the 11 listed banks, using a methodology that measures the weight of the capital impact, based on bank's current holdings of non-performing loans (NPL).

Bank	Core Capital to Risk Weighted Assets Ratio (Sep 17)	Adjusted Core Capital to Risk Weighted Assets Ratio*	Current Core Capital Buffer	Adjusted Core Capital Buffer	Change in Core Capital Buffer	Current Price to Book	Adjusted Price to Book
Equity Group	19.8%	18.4%	9.3%	**7.9%**	1.4%	1.9x	2.0x
NIC Bank	18.6%	16.1%	8.1%	**5.6%**	2.6%	0.7x	0.8x
KCB Group	17.4%	15.4%	6.9%	**4.9%**	2.0%	1.4x	1.5x
SCBK	17.1%	15.1%	6.6%	**4.6%**	1.9%	1.7x	1.9x
Coop Bank	15.9%	14.7%	5.4%	**4.2%**	1.2%	1.5x	1.6x
DTBK	16.5%	14.7%	6.0%	**4.2%**	1.8%	1.2x	1.4x
Barclays Bank	15.9%	14.6%	5.4%	**4.1%**	1.3%	1.3x	1.4x
I&M Holdings	16.1%	14.5%	5.6%	**4.0%**	1.6%	1.3x	1.4x
Stanbic Holdings	15.2%	13.9%	4.7%	**3.4%**	1.3%	1.1x	1.2x
HF Group	15.0%	11.6%	4.5%	**1.1%**	3.4%	0.4x	0.5x
NBK	9.8%	1.0%	(0.7%)	**(9.5%)**	8.8%	0.3x	6.8x
Average**	**17.3%**	**15.6%**	**6.8%**	**5.1%**	**1.7%**	**1.5x**	**1.6x**

- Assuming reporting under IFRS 9

***** - Market Cap Weighted***

According to our estimates, most of the listed banks, which compose the largest banks in the country, have adequate buffers to withstand the impact of IFRS 9. This is with the exception of NBK, which is already operating below the regulatory minimum requirement, and will need to shore up its capital base. In terms of valuations, the adjusted Price to Book (P/B) after adjusting for the impact of IFRS 9 is coming in at 1.6x, slightly above the current 1.5x, brought about by the deterioration in capital, brought about by an increase in NPLs as a result of IFRS 9 assets impairment framework, though the impact is cushioned by the fact that the new regulation will have minimal impact on the large banks, which current have sufficient core capital buffers.

According to the Ernst and Young (EY) European IFRS Banking Conference, the business response banks will be considering much more keenly going forward include:

i. strengthening of underwriting standards,
ii. better informed product pricing,
iii. increased use of financial guarantees, hedges and securitisation, and
iv. enhancement of governance around the use of standard contracts and new product approval.

While the large banks will have few problems navigating through IFRS 9, there are 3 banks that are already undercapitalised, namely NBK, Spire Bank and Consolidated Bank, which we expect will be the most affected banks. This may force, not only these banks, but the banks operating just above the regulatory minimum to seek additional capital from shareholders to shore up capital, and also enhance prudence in loan disbursement, which will ultimately have an adverse effect on private sector credit growth, which slumped to 2.0% in October 2017, way below the government target of

18.3%, and will inevitably prove detrimental to the economy. As noted in our Q3’2017 Banking Report, banks will have to be prudent in loan disbursement, as well as in providing for loans, following a relatively challenging operating environment, where banks are finding it increasingly difficult to price for risk. With the implementation of IFRS 9, and a few small banks possibly engaging in a survival battle, prudence may well turn into vigilance.