COVER STORY

Banks brace for MFRS 9 IMPACT

BY **ADELINE PAUL RAJ**

A new accounting standard — known as International Financial Reporting Standard 9 (IFRS 9) — that comes into force next year will have a significant impact on banks and inevitably affect borrowers and investors too, say experts.

IFRS 9, or MFRS 9 as the Malaysian equivalent is known, requires banks to change the way they make loan loss provisions. Banks will have to make provisions in anticipation of future losses rather than the current practice of making provisions only when loans have been classified as impaired.

This means that lenders will have to make provision for any new loan they extend, including undrawn facilities.

Given the drastic change in methodology, banks will see a jump in provisions, which could hurt earnings, weigh on their capital ratios and potentially affect dividend payouts. At least one banking group, Affin Holdings Bhd, tells The Edge that dividends are likely to be marginally lower, post-MFRS 9.

For the borrower, loans could eventually get more expensive.

Elaine Ng Yee Ling, a partner and leading expert on MFRS 9 at PwC, says that in trying to deal with the higher provisioning, it is possible banks may reprice or restructure loans, making it more expensive for borrowers with riskier credit profiles.

PWC, which is understood to be the market leader in advising banks on MFRS 9 implementation, estimates that for Malaysian banks, provisions could jump by between 25% and 50% on the first day of MFRS 9 adoption (known as Day One impact). Ultimately, the impact would vary from bank to bank, depending on their loan composition, customer risk profiles and regulatory reserve buffers.

"For every bank, the degree of the impact will be different. Even if the increase in provisions comes in at the higher end of the 20% to 50% range, Malaysian banks are quite well capitalised, so it's not going to be

Ng: The impact on profitability is the main concern

an immediate concern. The only thing here is the impact on profitability subsequently. That's the main concern," Ng says.

PwC's estimated 25% to 50% range for Day One impact suggests that the jump might be higher than that for most banks in Europe.

The European Banking Authority, which oversees regulators across the European Union, said two months ago that the majority of banks there expect their provisions to go up by as much as 18% after IFRS 9 is introduced, down from an estimate of as much as 30% last November. And, of the 50 banks that were surveyed, 72% anticipate that the standard will increase volatility in profit or loss.

With less than four months to go, Malaysian banks are scrambling to get ready for the accounting overhaul. According to Ng, banks are at different stages of readiness for MFRS 9, with some of the bigger ones having started preparing for it since late 2015.

"One or two are already doing parallel runs, which is important because that's when you really churn out the numbers and you can see the potential implications, and

What is MFRS 9?

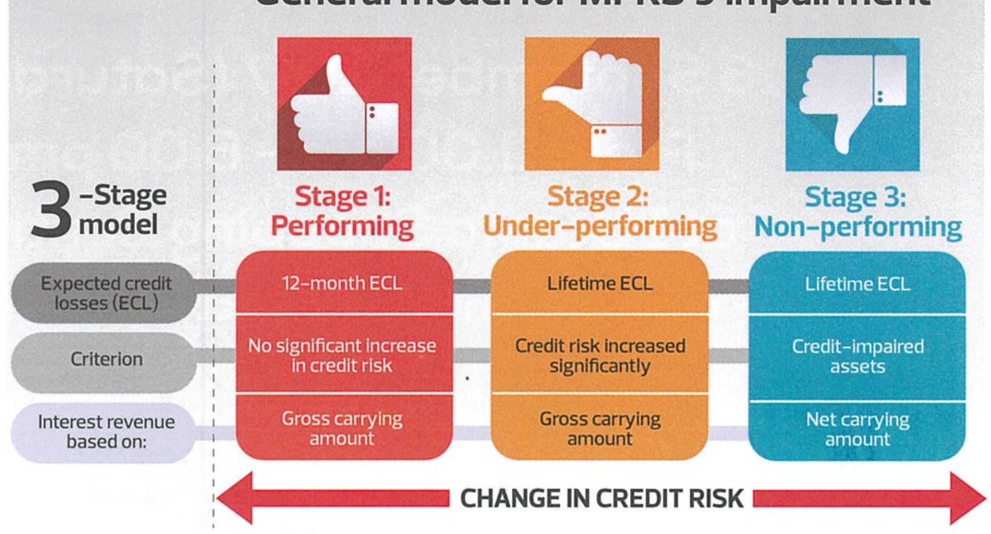
IFRS 9, or MFRS 9 as the Malaysian equivalent is known, is a complex accounting standard governing financial instruments that will replace IAS 39 (MFRS 139) next year. It will require banks to make provisions for expected losses in the future. Issued by the London-based International Accounting Standards Board, IFRS 9 was designed to address the "too little too late" criticism following the 2008/09 global financial crisis that banks were not able to account for losses until they were incurred even when it was apparent that they were coming.

For banks, the most significant change effected by the new standard will be their approach to impairment, although asset classification/measurement and hedge accounting will also be affected.

Loans can be in one of any three stages, as the general MFRS 9 model (below) shows. Loans that are performing and just originated fall under Stage 1 — where banks have to make provisions on the basis of projected losses over 12 months.

Loans are constantly assessed and fall into Stage 2 if there is a deterioration in credit quality. Banks will then have to provide over the expected life of the loan, like they do for Stage 3, under which non-performing loans fall.

General model for MFRS 9 impairment



New standard's effect not limited to banks

BY **SUPRIYA SURENDRAN**

It is not just banks that will be affected by MFRS 9. Pension funds like the Employees Provident Fund (EPF) and corporates that adhere to the Malaysian Financial Reporting Standards (MFRS) and International Financial Reporting Standards (IFRS) are expected to be impacted as well. However, experts say the impact on them will not be as significant as for the banks.

"MFRS 9 is a standard of financial instruments and therefore, its implementation is not confined to the financial reporting of banks," Malaysian Institute of Accountants (MIA) CEO Dr Nurmazilah Mahzan tells *The Edge*.

To assess the awareness and readiness of companies in implementing MFRS 9, the Securities Commission Malaysia says it is currently conducting a survey of 220 companies, excluding financial institutions, listed on the Main and ACE Markets, covering a diverse range of industries in Malaysia. Responses to the survey are due by mid-September.

"The significance and impact of MFRS 9 on corporates will depend on the financial assets and exposure that they have and how they are managed. Under the revamped forward-looking loss model, it is expected that higher impairment provisions will be required up front," an SC spokesperson tells *The Edge*.

The regulator expects all public-listed companies to be able to comply with the new accounting standard when it becomes mandatory on Jan 1, 2018.

The EPF, one of Asia's biggest retirement funds, had three significant categories of financial assets on its balance sheet as at Dec 31, 2016: investment assets held-to-maturity valued at RM228.07 billion; financial assets available for sale (AFS) at RM362.74 billion; and loans, advances and financing at RM93.11 billion.

The EPF's investments in equities are categorised under financial assets available for sale. Last year, the retirement fund's impairments swelled to a historical high of RM8.17 billion, with the bulk of it — RM8.05 billion — stemming from listed equities.

This led to the EPF declaring a dividend of 5.7% last year — the lowest since 2009. In contrast, the retirement fund paid a dividend of 6.4% in 2015 after recording impairments of RM3.07 billion.

These impairments were taken in accordance with MFRS 139. Now, with MFRS 9 taking over, what will happen to dividend payments? Will they be negatively affected? The answer, however, is not so simple.

This is because under MFRS 9, investments in equity instruments do not need to be assessed for impairment. Instead, they are measured at fair value with changes recognised in profit or loss, or at fair value with changes recognised through other comprehensive income.

The risk that accounting practitioners worldwide have been debating about IFRS 9, which is the international equivalent of MFRS 9, is whether these changes in fair value recognised in profit and loss would lead to more income statement volatility, which, in turn may affect dividend payments.

An industry observer tells *The Edge* that due to the technicalities of the transition to MFRS 9, it is still too early to gauge the impact the standard will have on dividend payments for retirement funds such as the EPF.

"I think it is premature to make assumptions about the impact on dividend payments and to judge whether it's a good thing or bad thing as the transition is made from MFRS 139 to MFRS 9. It comes down to what kind of methodology is used to measure the financial assets that would ultimately determine the impact on dividend payments, and I don't think anything has been set in stone yet at this point," he says.

The EPF declined to comment for this article.

Meanwhile, Nurmazilah says that while MIA does not express views on the financial statements of specific organisations, in general, it expects that under MFRS 9, the financial assets of pension funds would need to be classified according to their measurement categories, namely at amortised cost, at fair value through other comprehensive income, or at fair value through profit or loss.

Nurmazilah: MFRS 9 implementation is not confined to the financial reporting of banks

Vivek: Axiata will be reviewing its equity investment portfolio

For financial assets stated at fair value through profit or loss, no further impairment is assessed. Impairment for the other asset categories would use the general approach of MFRS 9.

"Under the general approach, the credit quality of the financial asset is compared at initial recognition (that is, when the financial asset is acquired) and at the reporting date. The change in the credit quality is split into three stages. For stage one, where the change in credit risk has not increased significantly, credit losses provided result from default events that are possible within the next 12 months.

"In stage two, where the change has increased significantly, a loss allowance is required for credit losses expected over the remaining life of the exposure (that is, lifetime expected credit losses). This is where the provisioning really gets heavier. As the credit risk worsens, it goes to stage three, which is when the financial asset is credit impaired.

"The simplified approach, on the other hand, is more straightforward as it provides lifetime expected credit losses, regardless of the credit risks attached to the asset. Although no judgement is required to assess whether the changes in credit risk are significant or not, entities will be required to provide for lifetime credit losses instantly. The simplified approach [for impairment of financial assets] is only available for trade receivables, contract assets and lease receivables," says Nurmazilah.

For corporates, she says those that carry huge trade debtor balances may also be impacted by the standard as accounts receivables or trade debtors are financial assets.

"Corporations with huge consumer-based receivables, such as telecommunications and utility companies, could see an impact.

"However, the extent of the impact differs from that on banks [due to the recoverability period] ... when banks give out loans, there will be a payback period of 5 to 20 years, which is a longer term.

"In the telecoms industry, for example, when a subscriber doesn't pay the bill after a month, the line gets cut. The implementation context of MFRS 9 here is different

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from there you can fine-tune your model. For example, you can see which segments in your portfolio carry higher expected credit losses (ECL), and which will be affected most by macroeconomic variables and so on. Banks may want to reconsider the strategy for those segments that are more sensitive or volatile," Ng explains.

Malayan Banking Bhd (Maybank) says it is currently on a parallel run and refining its MFRS 9 methodology.

Banks will be required to switch to an expected loss model, as opposed to the incurred loss model they now use under MFRS 139.

For a performing loan, lenders will have to make provisions on the basis of projected losses over 12 months. However, if there are signs that the credit quality of that loan is deteriorating, then losses will have to be booked over the loan's entire lifetime.

"One would expect that provisions will go up significantly upon MFRS 9 adoption. However, on transition, such provision will be adjusted through the opening balance sheet, that is, retained earnings and loss allowance as at Dec 31, 2017, figures (for December year-end entities)," says Malaysian Institute of Accountants (MIA) CEO Dr Nurmazilah Mahzan.

There will be no impact on a bank's profit and loss (P&L) on Day One. Any movements in impairment allowances after that, however, will be recorded in and affect the bank's P&L.

What the banks say

Of the six banking groups that responded to questions sent by *The Edge*, most acknowledge that annual provisions will go up but say the impact on their CET-1 capital on Day One will be manageable, especially if Bank Negara Malaysia allows them to offset the higher provisions against regulatory reserves (RR).

Bank Negara, in response to questions sent by *The Edge* (see next page), stated that any increase in provisioning under MFRS 9 will be significantly offset by existing RR that banks have been required to set aside since 2015.

All six banks — Maybank, CIMB Group Holdings Bhd, Hong Leong Bank Bhd, RHB Bank Bhd, AMMB Holdings Bhd and Affin Holdings Bhd — say they are on track with their respective plans for MFRS 9 adoption. However, they do not indicate to what extent their annual earnings would be impacted.

Maybank chief financial officer Datuk Amirul Feisal Wan Zahir says based on its initial impact assessment, the potential reduction in the group's capital ratios could range between 60 and 90 basis points for Day One adjustment to retained earnings on Jan 1, 2018.

The group's capital ratios will nevertheless remain resilient post-MFRS 9 as they are among the strongest in the region, he says. As at June 30, its total capital ratio stood at 19.98% while its CET-1 ratio was at 13.56% (after a proposed dividend, assuming 85% reinvestment.)

"Furthermore, the potential reduction in Maybank group's capital ratios arising from Day One impact can be mitigated if banks are allowed to offset the higher allowances for impairment losses against RR buffers," he says.

On whether loans may become more expensive for the borrower post-MFRS 9, he says, "Any impact on risk-based pricing would vary depending on the duration of the financing facility. However, this would not necessarily translate into higher cost to borrowers across the board."

AMMB group CEO Datuk Sulaiman Mohd Tahir, however, reckons that banks may offer shorter tenure loans, post MFRS 9, as a measure to manage and reduce lifetime ECL.

"The limits of loan commitments extended to customers may also be impacted due to the requirement to recognise ECL on loan commitments provided to customers," he remarks.

Indeed, PwC's Ng points out that in the past, banks may have liked to stretch loans because it would give them recurring income. "Now, they have to think it through for borrowers with not very good credit rating," she explains.

Industry observers say unsecured loans such as personal financing and credit cards, which are high-risk, high-margin products, may also be a grey area for banks. Banks will also have to carry provisions for credit card limits, and thus may consider reducing the limit for some customers.

Maybank's Amirul, however, does not expect the group to slow down certain loans

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No detrimental impact on non-banks

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due to the nature of business," she says.

Axiata Group Bhd chief financial officer Vivek Sood says the group is in the process of identifying the potential impact of MFRS 9.

Areas of focus for Axiata include hedge instruments/derivative financial instruments, receivables and investments.

"As the new accounting guidelines provide a broader effectiveness test on hedging, we see certain economic hedge instruments where Axiata could be eligible and qualify for hedge accounting.

"Once qualified, the fair value of the economic hedge instrument will be taken to hedge reserves rather than to profit or loss," says Vivek.

As for receivables, he says the new MFRS 9 methodology will apply to receivables of postpaid customers, finance lease receivables, interconnect customers and other trade-related receivables.

"On investments, Axiata will be reviewing its equity investment portfolio and will take appropriate action with the new standard allowing fair value through other comprehensive income instead of fair value through profit or loss," he explains.

A DiGi.Com Bhd spokesman tells *The Edge* that the telco sees minimal financial impact from adopting the new standard.

"MFRS 9 mainly changes the classification and measurement of financial assets. The largest component of financial assets on DiGi's book is receivables, where the standard allows the application of a simplified approach as a practical expedient.

"Our preliminary assessment indicates that implementation of MFRS 9 will have no significant impact on DiGi's receivables or financials."

PwC assurance partner and risk assurance services leader Elaine Ng Yee Ling opines that the implementation of MFRS 9 at non-banks will not have a detrimental impact. "It's not going to be so significant. It won't shake them. For non-banks, it's more about getting ready for the implementation as the excessiveness is less compared with banks.

"For example, when it comes to disclosure, under the general approach, banks need to disclose stages one to three for the expected losses provisioning model, but for telcos that apply the simplified approach, [the disclosure is not so detailed] as lifetime expected credit losses are applied throughout," she says. E

Banking stocks may lose shine

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as a result of MFRS 9. "We do not expect this to be so as we will continue to maintain the same prudence in our underwriting practices."

AMMB, which has a March 31 financial year end, will transition to MFRS 9 only on April 1 next year. "Transitioning to (the new standard) will result in movements in the allowance for impairment losses. Offsetting this additional impairment allowance, there will be fair value gains arising from certain financial assets that are currently not measured at fair value under MFRS 139. Consequently, the impact on CET-1 is expected to be neutral," Sulaiman says.

He adds, however, that it is currently too early to predict reliably the impairment allowance upon MFRS 9 adoption. "Our capitalisation is more than adequate," he says, adding that AMMB would strive to maintain a consistent annual dividend payout.

Meanwhile, CIMB Group indicates that it does not expect MFRS 9 to throw it off its key targets for end-2018 under its T18 plan.

"At this stage, we expect the impact on capital to be manageable within our capital plans to achieve our targeted CET-1 ratio of 12% for the group by end-2018," group CEO Tengku Datuk Seri Zafrul Aziz says.

Hong Leong Bank group CEO Domenic Fuda says from a business perspective, there will be various elements the group will need to consider upon adoption of MFRS 9.

"For instance, loan tenure and credit limit offered to customers are some of the key items to be considered by the bank in determining its business strategies going forward. The ability to proactively manage collection efforts and having access to dynamic data analytics are also important," he says.

It is premature to assess the potential impact on dividend payment to shareholders, he adds.

Affin Holdings, the country's second smallest bank, says based on its preliminary assessment, there will be an increase of about 50% in its total provisions upon the adoption of MFRS 9.

The group's balance sheet is strong enough to weather the impact of MFRS 9, its group CEO Kamarul Ariffin Mohd Jamil says. "Based on impact assessment, the impact on the capital adequacy ratio is less than 1% to the group, which is well within the capital requirements level under Basel III."

He reveals that the group's estimated cost for MFRS 9 implementation is about RM5 million this year.

Teething problems

Meanwhile, banking stocks, which investors have chased up this year, may lose some of their shine because of the uncertainties surrounding MFRS 9.

"The adoption of MFRS 9 in 2018 will create uncertainties for banks' earnings, which, in turn, would affect the sentiment on banking stocks," says CIMB Research. In a report entitled *Beware the opening of MFRS 9 Pandora's Box in 2018* two months ago, it downgraded its investment call on the banking sector to "neutral" from "overweight". Most research houses have a neutral stance on the sector.

CIMB Research estimates that a 10% to 50% increase in banks' credit cost arising from the adoption of MFRS 9 will lower their FY2018-FY2019 net profit by between 1.3% and 8.3%.

"We expect the negative impact from adoption of MFRS 9 on net profit will be the largest for Maybank at 2.3% for every 10% increase in loan loss provisioning. We believe the net impact will be the smallest at only 0.4% and 0.6%, respectively, for Hong Leong Bank and Public Bank (for every 10% rise in loan loss provisioning)," it says, based on its simulation.

While Public Bank has remained largely silent on its MFRS 9 preparation, analysts note that it is likely to weather the impact the best. The fact that it has the highest loan loss reserves buffer among the banks at 249%, inclusive of RR, is "a major positive", says UOB Kay Hian Research.

In Malaysia, the banking system had gross non-performing loans of RM26.1 billion as at end-July while the gross impaired loan ratio stood at 1.68%.

Investors will be able to see the impact on the banks from their first-quarter results next year, at least for those with a Dec 31 financial year end.

It becomes even more important now that investors read the banks' disclosures.

"When they (banks) prepare their financial statements, the disclosures they make will be the story, where they have to explain how they assess the loans and the considerations that went into it. Because the standard is principle based, there is a lot of judgement involved, for example, judgement on how you move from Stage 1 to Stage 2," notes MIA's Dr Nurmazilah.

Disclosures are expected to get more complicated and it will be increasingly tough to compare one bank's performance with another given that each bank's ECL model will be different.

"It can be very different, especially because of the forward-looking element. In the model, there's Stage 1,2,3, and on top of all this, you need to include macroeconomic variables. So you plot the GDP, unemployment, inflation ... it will be different for every bank. The one that has more optimistic views will likely have lower provisions," says PwC's Ng.

"There are some elements where management judgement will come into play. And so, it's very important that there is a strong governance framework around all this," she adds.

What is certain is that banks are in for a challenging time as they adjust to MFRS 9.

"As with any new regulation, first time implementation is always difficult but encourages discussion and debate. It will be challenging ... a teething process," Nurmazilah remarks.

In Asean, Thailand and Indonesia are the only two major countries postponing the adoption of IFRS 9 to 2019. E

Any increase in provisioning will be offset by existing regulatory reserves, says Bank Negara

The implementation of MFRS 9, which will supersede MFRS 139, is a more forward-looking approach to provisioning practices, where banking institutions are required to estimate expected credit losses throughout the lifetime of the loan/financing exposure. This is in contrast to MFRS 139, where provisions are recognised only when there is an objective evidence of impairment. This new approach is expected to further enhance practices on impairment and risk management, thereby strengthening the soundness of financial institutions and the overall financial system.

While banking institutions are expected to set aside higher provisions under MFRS 9, the magnitude of impact on earnings and capital is within Bank Negara's expectations and consistent with global trends.

Malaysian banking institutions will transition to MFRS 9 from a position of strength, cushioned by the requirement to set aside regulatory reserves since 2015. Under the current prudential requirement, banking institutions are required to maintain collective impairment provisions of not less than 1.2% of total loans. Where the 1.2% minimum is not met, the banking institution is required to set aside regulatory reserves to ensure an adequate level of buffers for potential credit losses. Thus, any increase in provisioning under MFRS 9 will be significantly offset by existing regulatory reserves.

Bank Negara also does not expect MFRS 9 to have a material impact on financial intermediation, given the strong level of capitalisation of Malaysian banks. As at end-June 2017, the banking system had a Common Equity Tier 1 (CET-1) and Total Capital Ratio of 12.9% and 17% respectively, well above the regulatory minimum of 4.5% and 8%.

To ensure smooth implementation when the standard comes into force on Jan 1, 2018, Bank Negara will continue to work with the financial industry and other key stakeholders, including auditors and advisory firms, to identify and address any implementation issues. E

This is Bank Negara Malaysia's response to *The Edge*'s questions on MFRS 9

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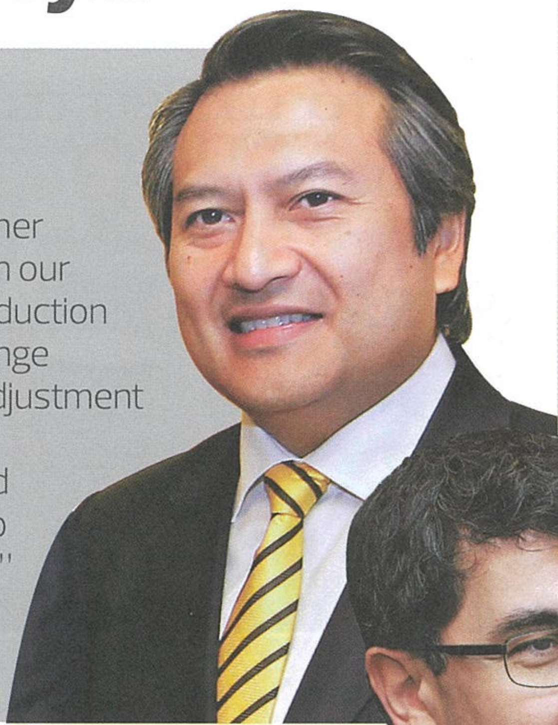
What the bankers say...



MAYBANK

"The adoption of MFRS 9 will result in a higher allowance for impairment losses. Based on our initial impact assessment, the potential reduction to Maybank Group's capital ratios could range between 60bps and 90bps for Day One adjustment to retained earnings on Jan 1, 2018. Maybank has a long-term annual dividend payout policy of 40% to 60%. We intend to maintain that payout policy, post MFRS 9."

— Group CFO Datuk Amirul Feisal Wan Zahir

HONG LEONG BANK

"Based on the latest assessment, we are expecting additional provisions of between 20% and 30% to be reflected as Day One charge to be adjusted against reserves. This has not incorporated the impact of forward-looking macroeconomic variables (MEV), in which the MEV methodology is still undergoing development and refinement at various stages."

— Group CEO Domenic Fuda

CIMB GROUP

"There may be an increase in provisions at the initial stage depending on, inter alia, the type, duration and repayment history of loans, as well as market conditions. Overall, we believe that the impact of MFRS 9 on our balance sheet, capital and profitability will be entirely manageable in terms of achieving our T18 targets."

— Group CEO Tengku Datuk Seri Zafrul Aziz

AFFIN HOLDINGS

"There will be an increase of 50% in the total provision upon the adoption of MFRS 9 (based on preliminary assessment). The group's balance sheet is strong enough to weather the impact. Dividends are expected to be marginally lower post-MFRS 9."

— Group CEO Kamarul Ariffin Mohd Jamil

RHB BANK

"RHB's balance sheet remains sound and capital (ratios) are at comfortable levels, taking into account the potential impact of MFRS 9 adoption. We do not see MFRS 9 adoption changing the process that we follow to determine dividend payout, which will continue to be based on a number of different considerations, including the sustainability of the bank's capital ratios."

— Group CFO Syed Ahmad Taufik Albar

AMMB HOLDINGS

"A slowdown in the (banking industry's) offering of loans is not expected. Nevertheless, the new impairment requirements of MFRS 9 may result in shorter tenure loans. The limit of loan commitments extended to customers may also be impacted due to the requirement to recognise expected credit losses on loan commitments provided to customers."

— Group CEO Datuk Sulaiman Mohd Tahir