THE EFFECT OF IFRS 9 IMPLEMENTATION ON THE KENYAN FINANCIAL SERVICES SECTOR

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Common Equity Tier 1 (CET1) Capital

Core Capital (Tier 1) is permanent shareholders' equity (issued and fully paid-up ordinary shares and perpetual non-cumulative preference shares), disclosed reserves such as ordinary share capital and perpetual non-cumulative share premium, retained earnings and 50% un-audited after tax profits, less investments in subsidiaries conducting banking business, investment in equity instruments of other institutions, intangible assets (excluding computer software) and goodwill. The current year to date 50% un-audited after tax profits will qualify as part of core capital, if and only if, the institution has made adequate provisions for loans and advances, proposed dividends and other appropriations have been deducted.

Effects

- IFRS 9 will align measurement of financial assets with the bank's business model, contractual cash flow of instruments, and future economic scenarios.
- In addition, the IFRS 9 provision framework will make banks evaluate how economic and credit changes will alter their business models, portfolios, capital, and the provision levels under various scenarios.

Urgent matter

IFRS 9 is more principles-based than any other standard that has gone before it, which means it can be open to interpretation. An early assessment of the impacts on provision levels is an absolute necessity.

Talk to your auditors to find out different ways of implementing that are right for your business.

You need to know the best strategy for reducing the cost of the system, given your structure. Now is also the time to be speaking with your internal colleagues to identify the wider considerations and implications of any decisions. If you have not already started, you are late. Get going.

Think widely

IFRS 9 is something that should be done in a stepwise manner. One of the main reasons for a step-by-step approach is because each step may lead to changes that could have a knock-on effect elsewhere. The IFRS 9 provision calculation requires integration of multiple processes across different areas, including risk, finance, and accounting. That means you need to look at the holistic picture with each step you take. Think widely and cross-functionally to get the best understanding of your economic exposures, and do not try to boil the ocean by doing it all in one go.

Put a dedicated budget in place

One of the biggest "lessons learned" from companies going through this process is that they failed to put a dedicated budget in place at the outset. They have then had to scramble to pull time and resources together as they progress across different steps. Everyone focuses on the compliance requirements and the hard deadline, but regulation budgets are often overlooked. They can consume considerable resources and software. Yet reporting, by nature, involves at least two parties (and usually more), so there will always be an impact on someone. Companies often say they are surprised at the time and budget of changing content and technical requirements around reconciliation efforts, for example. Avoid the pitfalls by thinking ahead about what is required.

The change

The most significant change with IFRS 9 lies in handling impairment. The old IAS39 has foreseen an “occurred loss model”. Impairment Accounting needed only to be performed for assets with a significant default probability or for already defaulted assets. The criticism in this approach lies in not reflecting unexpected market movements like we saw in the financial crisis 2008ff. So IFRS9 requires a more forward looking “expected loss model”, that also monitors a potential credit rating deterioration over time, e.g. once Issuers like countries or organizations are rated down, the Investor needs to follow that in accounting. SAP Investment Accounting Solutions can support Insurance Companies, Pension Funds, Banks and other Investors with comprehensive functionalities around Impairment Accounting (and other IFRS9 relevant functionalities) like:

- Impairment stage handling
- book value component handling upon purchase/sale/redemption
- book value component handling at monthly/quarterly closings

Use IFRS 9

As technology continues to automate much of the operational work, the role of treasurer is evolving.

Take a wider view of the business with consultative input, rather than just keeping the books clean.

With that in mind, IFRS 9 gives an opportunity to take a fresh look at some processes and strategies. For example, are the accounting systems tightly integrated to the treasury solution, or do you need to upload all the data, replicate the system, and bring all the data back again? Part of your consultative remit means looking ahead to future-proof your systems for seamless integration and a smooth implementation path.

UK Survey

The survey captures the views of 100 senior decisions makers responsible for IFRS 9 within their organisation. Sectors interviewed included UK banks, building societies and consumer, auto and SME finance. Those interviewed covered a range of different job functions to discover how each department views their progress towards compliance, including: • Credit Risk; • Finance; • Regulation and Compliance; • Economics; • IT

Deadlines?

It is unclear if all lenders will meet the January 2018 deadline, but one thing is for sure, the regulators are sure to shine a spotlight on organisations who are seen to be lagging behind or adopting inadequate
approaches.
Although IFRS 9 implementation may pose numerous challenges to ways of working, it also provides many opportunities for organisations to benefit from improved business operations.

The effect on Barclays (1)

- The period reported on is the 9 months to 30 September 2017.
- Barclays Africa has been sold already.
- Barclays estimates that the IFRS 9 impact, based on its portfolio as at 30 September 2017, is a decrease in shareholders' equity of approximately £2.0bn post tax. Its market capitalization as at 30 September 2017 was £43.58 bn (on 29 January 2018 it was £49.86 bn).
- The estimated decrease in shareholders' equity includes the impact of both balance sheet classification and measurement changes and the increase in credit impairment provisions compared to those applied at 30 September 2017 under IAS 39.

The effect on Barclays (2)

- The adoption of certain classification and measurement accounting changes remain subject to endorsement by the European Union.
- This assessment is a point of time estimate and is not a forecast.
- The actual effect of the implementation of IFRS 9 on Barclays PLC could vary significantly from this estimate.
- Barclays continues to refine models, methodologies and controls, and monitor developments in regulatory rule-making in advance of IFRS 9 adoption on 1 January 2018.
- All estimates are based on Barclays' current interpretation of the requirements of IFRS 9, reflecting industry guidance and discussions to date.

The effect on Barclays (3)

- The Group's CET1 ratio will be impacted by IFRS 9 primarily from an increase in credit impairment provisions net of tax and any deduction of deferred tax assets arising from temporary differences being in excess of the allowable regulatory allowable threshold.
- This is partially offset by a reduction in the regulatory expected loss over impairment deductions and reduced RWAs (Rise Weighted Assets)
- Based on figures as at 30 September 2017, the expected CET1 impact without transitional arrangements would be an estimated reduction of approximately 40 bps.

The effect on Barclays (4)

- Barclays expects to implement transitional arrangements for capital purposes, currently being finalized by European Regulators, which would result in only a proportion of the estimated reduction impacting the CET1 ratio during 2018.
- The final impact of IFRS 9 is estimated to be approximately 20 bps lower than the point in time impact as deferred tax assets are expected to fall below the allowable threshold over time.
- Barclays plans to publish transitional disclosures during the first quarter of 2018 describing the 1 January 2018 impact of adoption of IFRS 9.

Lloyds Banking Group

- IFRS 9 : The Group's IFRS 9 implementation is nearing completion, including embedding of the new systems and processes.
- It is currently expected that the CET1 capital impact before any transitional relief will be a reduction of between 10 to 30 basis points after taking account of any offset against regulatory expected losses, mainly as a result of additional impairment provisions.
- As a consequence, on transition IFRS 9 is not expected to have a material impact on the Group's capital position.

Royal Bank of Canada(1)

In January 2015, the Office of the Superintendent of Financial Institutions Canada (OSFI) issued an advisory with respect to the early adoption of IFRS 9 for Domestic Systemically Important Banks (D-SIBs), requiring D-SIBs to adopt IFRS 9 for the annual period beginning on November 1, 2017. As a result, we are required to adopt IFRS 9 on November 1, 2017, with the exception of the own credit provisions of IFRS 9, which we adopted in the second quarter of 2014. In June 2016, OSFI issued its final guideline on IFRS 9 Financial Instruments and Disclosures. The guideline provides guidance to Federally Regulated Entities on the application of IFRS 9, including the implementation of the expected credit loss framework under IFRS 9.

Royal Bank of Canada(2)

The OSFI guideline is effective for us on November 1, 2017, consistent with the adoption of IFRS 9. The new classification and measurement and impairment requirements will be applied by adjusting our Consolidated Balance Sheet on November 1, 2017, the date of initial application, with no restatement of comparative period financial information. Based on current estimates, the adoption of IFRS 9 is expected to result in a reduction to retained earnings as at November 1, 2017 of approximately $600 million, net of taxes. The impact is primarily attributable to increases in the allowance for credit losses under the new impairment requirements. We do not expect the adoption of IFRS 9 to have a significant impact on our CET1 capital. We continue to monitor and refine certain elements of our impairment process in advance of Q1 2018 reporting.

Royal Bank of Canada(3)

Equity attributable to shareholders (Note 21)	2017	2016
	$m	$m
Preferred shares	6,413	6,713
Common shares (shares issued – 1,452,534,303 and 1,484,234,375)	17,703	17,859
Retained earnings	45,359	41,519
Other components of equity	4,354	4,926
	73,829	71,017

Royal Bank of Canada(4)

	2017	2016
Consolidated Statement of Income	$m	$m
Provision for credit losses (Note 5)	1,150	1,546
Consolidated Balance Sheet		
Loans (Note 5)		
Retail	385,170	369,470
Wholesale	159,606	154,369
	544,776	523,839
Allowance for loan losses (Note 5)	(2,159)	(2,235)
	542,617	521,604

Royal Bank of Canada(4)

October 31, 2017 (Millions of Canadian dollars)	Canada	United States	Other International	Total
Retail: Residential mortgages	$255,799	$11,449	$3,100	$270,348
Personal	82,022	6,357	3,915	92,294
Credit cards	17,491	294	250	18,035
Small business	4,493	–	–	4,493
	359,805	18,100	7,265	385,170
Wholesale: Business	74,425	51,556	20,310	146,291
Banks	1,027	2,498	437	3,962
Sovereign	7,370	934	1,049	9,353
	82,822	54,988	21,796	159,606
Total loans	442,627	73,088	29,061	544,776
Allowance for loan losses	(1,406)	(234)	(519)	(2,159)
Total loans net of allowance for loan losses	$441,221	$72,854	$28,542	$542,617

RBC: Classification & measurement (1)

- IFRS 9 introduces a principles-based approach to the classification of financial assets.
- Debt instruments, including hybrid contracts, are measured at fair value through profit or loss (FVTPL), FVOCI or amortized cost based on the nature of the cash flows of the assets and an entity's business model.
- These categories replace the existing IAS 39 classifications of FVTPL, AFS (available for sale), loans and receivables, and held-to-maturity.
- Equity instruments are measured at FVTPL, unless they are not held for trading purposes, in which case an irrevocable election can be made on initial recognition to measure them at FVOCI with no subsequent reclassification to profit or loss.

RBC: Classification & measurement (2)

- For financial liabilities, most of the pre-existing requirements for classification and measurement previously included in IAS 39 were carried forward unchanged into IFRS 9.
- The requirements related to the fair value option for financial liabilities, which were adopted in 2014, were changed to address the treatment of own credit risk.

RBC: Classification & measurement (3)

The combined application of the contractual cash flow characteristics and business model tests as at November 1, 2017 is expected to result in certain differences in the classification of financial assets when compared to our classification under IAS 39. The most significant changes include the following:

- Approximately $25 billion debt securities previously classified as AFS are expected to be classified as amortized cost based on a held-to-collect business model.
- Approximately $2.5 billion securities previously classified as AFS are expected to be classified as FVTPL, primarily representing equities and debt securities whose cash flows do not represent solely payments of principal and interest.

RBC: Impairment (1)

- IFRS 9 introduces an expected credit loss impairment model that differs significantly from the incurred loss model under IAS 39 and is expected to result in earlier recognition of credit losses. Additional details on the key elements of the new expected credit loss model are described below.
- Scope: Under IFRS 9, the same impairment model is applied to all financial assets, except for financial assets classified or designated as at FVTPL and equity securities designated as at FVOCI, which are not subject to impairment assessment.

RBC: Impairment (2)

- The scope of the IFRS 9 expected credit loss impairment model includes amortized cost financial assets, debt securities classified as at FVOCI, and off balance sheet loan commitments and financial guarantees which were previously provided for under IAS 37 Provisions, Contingent Liabilities and Contingent Assets (IAS 37).
- The above-mentioned reclassifications into or out of these categories under IFRS 9 and items that previously fell under the IAS 37 framework were considered in determining the scope of our application of the new expected credit loss impairment model.

RBC: Impairment (3)

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- The above-mentioned reclassifications into or out of these categories under IFRS 9 and items that previously fell under the IAS 37 framework were considered in determining the scope of our application of the new expected credit loss impairment model.

Expected credit loss impairment model (1)

Under IFRS 9, credit loss allowances will be measured on each reporting date according to a three-stage expected credit loss impairment model:

• Stage 1 – From initial recognition of a financial asset to the date on which the asset has experienced a significant increase in credit risk relative to its initial recognition, a loss allowance is recognized equal to the credit losses expected to result from defaults occurring over the next 12 months.

• Stage 2 – Following a significant increase in credit risk relative to the initial recognition of the financial asset, a loss allowance is recognized equal to the credit losses expected over the remaining lifetime of the asset.

Expected credit loss impairment model (2)

- • Stage 3 – When a financial asset is considered to be credit-impaired, a loss allowance equal to full lifetime expected credit losses will be recognized. Interest revenue is calculated based on the carrying amount of the asset, net of the loss allowance, rather than on its gross carrying amount.
- Stage 1 and Stage 2 credit loss allowances effectively replace the collectively-assessed allowance for loans not yet identified as impaired recorded under IAS 39, while Stage 3 credit loss allowances effectively replace the individually and collectively assessed allowances for impaired loans.

Expected credit loss impairment model (2)

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Expected credit loss impairment model (3)

- Under IFRS 9, the population of financial assets and corresponding allowances disclosed as Stage 3 will not necessarily correspond to the amounts of financial assets currently disclosed as impaired in accordance with IAS 39.
- Consistent with IAS 39, loans are written off when there is no realistic probability of recovery.
- Accordingly, our policy on when financial assets are written-off will not significantly change on adoption of IFRS 9.

Expected credit loss impairment model (4)

Under IFRS 9, the population of financial assets and corresponding allowances disclosed as Stage 3 will not necessarily correspond to the amounts of financial assets currently disclosed as impaired in accordance with IAS 39. Consistent with IAS 39, loans are written off when there is no realistic probability of recovery. Accordingly, our policy on when financial assets are written-off will not significantly change on adoption of IFRS 9. Because all financial assets within the scope of the IFRS 9 impairment model will be assessed for at least 12-months of expected credit losses, and the population of financial assets to which full lifetime expected credit losses applies is larger than the population of impaired loans for which there is objective evidence of impairment in accordance with IAS 39, loss allowances are generally expected to be higher under IFRS 9 relative to IAS 39.

Expected credit loss impairment model (5)

- Changes in the required credit loss allowance, including the impact of movements between Stage 1 (12 month expected credit losses) and Stage 2 (lifetime expected credit losses), will be recorded in profit or loss. Because of the impact of moving between 12 month and lifetime expected credit losses and the application of forward looking information, provisions are expected to be more volatile under IFRS 9 than IAS 39.
- Measurement: The measurement of expected credit losses will primarily be based on the product of the instrument's probability of default (PD), loss given default (LGD), and exposure at default (EAD), discounted to the reporting date. The main difference between Stage 1 and Stage 2 expected credit losses is the respective PD horizon.

Expected credit loss impairment model (6)

- Stage 1 estimates will use a maximum of a 12-month PD while Stage 2 estimates will use a lifetime PD.
- Stage 3 estimates will continue to leverage existing processes for estimating losses on impaired loans, however, these processes will be updated to reflect the requirements of IFRS 9, including the requirement to consider multiple forward-looking scenarios.
- An expected credit loss estimate will be produced for each individual exposure, including amounts which are subject to a more simplified model for estimating expected credit losses; however the relevant parameters will be modeled on a collective basis using largely the same underlying data pool supporting our stress testing and regulatory capital expected loss processes.
- Models have been developed, primarily leveraging our existing models for enterprise-wide stress testing.

Expected credit loss impairment model (7)

- For the small percentage of our portfolios that lack detailed historical information and/or loss experience, we will apply simplified measurement approaches that may differ from what is described above. These approaches have been designed to maximize the available information that is reliable and supportable for each portfolio and may be collective in nature.
- Expected credit losses must be discounted to the reporting period using the effective interest rate, or an approximation thereof.

Transition (1)

To manage our transition to IFRS 9, we implemented a comprehensive enterprise-wide program led jointly by Finance and Risk Management that focuses on key areas of impact, including financial reporting, data, systems and processes, as well as communications and training. Throughout the project, we have provided regular updates to the Audit Committee, Risk Committee and senior management to ensure escalation of key issues and risks. During fiscal 2015 and 2016, we completed initial assessments of the scope of IFRS 9, differences from IAS 39, classification of financial assets, financial and economic impacts, system and resource requirements, and key accounting inter-pretations. We also designed and began building the systems, models, controls and processes required to implement IFRS 9.

Transition (2)

ICPAK
Uphold Public Interest

During fiscal 2017, we completed the following steps:

• Completed a parallel run of the full end to end process during the fourth quarter of 2017, the results of which were used to test our

models and methodologies against our key performance indicators;

• Validated significant new impairment models;

• Completed documentation of updated bank-wide accounting and risk policies;

Transition (3)

- Finalized governance and control frameworks over new processes and testing of internal controls;
- Documented the roll-out and implementation of the IFRS 9 project and governance structure including key controls;
- Continued to provide training and educational seminars to impacted internal stakeholders; and
- Prepared external disclosures to be provided on transition to IFRS 9 and going forward on a quarterly or annual basis.

Nimesh Verma, BNP Paribas (1)

- Under IFRS 9, the carrying value of loan assets – which has been at amortised cost for hundreds of years – will change to incorporate modelled, forward-looking, volatile expected losses. As the accounting value of loans forms a key input to regulatory solvency, banks face immediate one-off hits to regulatory solvency when expected losses and lifetime expected losses increase significantly, relative to current provisioning and regulatory deductions. Interestingly, recent bank disclosure shows one-off hits to solvency to be manageable – a fall of 45 basis points in Common Equity Tier 1 ratio in the recent European Banking Authority (EBA) impact assessment, for example.

Nimesh Verma, BNP Paribas (2)

This is lower than initially expected because of continued heavy provisioning and improved economic outlooks. More importantly, IFRS 9 significantly increases volatility and procyclicality. It amplifies provision levels and drives large shifts in regulatory capital on an ongoing basis, as changes in economic outlook mean swaths of assets move between stages 1 and 2. At the same time, given amplified provisioning, we expect stress scenario impacts to swing wildly – with much higher impact for the same stress scenarios under IFRS 9 than under current standards.

Credit funds (1)

- Under IAS 39, financial assets were classified into several disjointed categories, which were arguably misaligned with the requirements of financial statement users.
- This classification system was subject to criticism due to its complexity.
- The purpose of IFRS 9 has therefore been to simplify and improve the accounting for investments.
- Importantly, the new standard makes a clear distinction between accounting for investments at Fair Value and amortized cost. These changes are expected to be widely welcomed by institutional investors in alternative investment funds, which almost universally require NAV statements to be prepared based on Fair Value.

Credit funds (2)

- Fair Value is typically required by institutional investors for their own financial reporting purposes.
- Pension funds and funds of funds often use Fair Value as a common basis to make asset allocation and investment manager selection decisions.
- Fair Value is also used in the performance evaluation process and can therefore inform incentive compensation decisions. In the absence of consistent and transparent information concerning the Fair Value of underlying investments, institutional investors may face challenges in exercising their fiduciary responsibilities, including the need to measure and control risk.

Credit funds (3)

- These drivers have led institutional investors in alternative investment funds to become increasingly insistent on Fair Value measurement and these investors have become more sophisticated in communicating this to general partners in recent years.
- In certain circumstances, IFRS 9 allows banks and other financial institutions to hold loan books at amortized cost. This is not a path, however, that will be acceptable to institutional investors in the alternative investment (private equity, hedge funds, managed futures, real estate, commodities and derivatives contracts) funds sector.
- To measure and report fund investments at amortized cost is now seen by many as a disservice, given the overwhelming need of these investors for Fair Value.

Credit funds (4)

If satisfying investor requirements were not enough to convince CFOs to apply Fair Value measurement, following the 'cash flow characteristics' and 'business model' tests under IFRS 9 will inevitably lead sophisticated general partners to conclude that Fair Value is the only viable option for private debt investments.

Credit funds (5)

- A private debt investment may be accounted for at amortized cost only if, firstly, the investment gives rise on specified dates to cash flows that are solely payments of principal and interest and, secondly, the investment is held within a business whose sole objective is to hold financial assets to maturity to collect contractual cash flows.
- Applying these tests, the use of amortized cost would preclude many of the unique strategies and terms used by alternative investment funds to enable them to target excess returns. The preference for most general partners for strategies with sufficient flexibility to enable them to generate returns for investors should naturally lead most alternative investment funds towards Fair Value measurement.

Credit funds (6)

While there may be a temptation for some alternative investment funds to see amortized cost as an "easy option" for private debt investments, this would be counterintuitive to fund business models, as any perceived failure to report Fair Value can be discouraging for institutional investors. There can be no more hiding under the new standard, since IFRS 9 makes clear that historical cost and amortized cost are not proxies for Fair Value.

Credit funds (7)

In the rare circumstances that a fund chooses to measure private debt investments at amortized cost, they will now be required to perform more onerous impairment testing under IFRS 9, which must include a forward-looking assessment of expected credit losses. This will be similar to the analysis performed by banks and other financial institutions.

Alternative investment funds should carefully consider the needs of investors when applying IFRS 9 for the first time. Investors and audit firms are becoming more aware of the issues and the choices that CFOs have in this regard. Given the introduction of IFRS 9 and the ongoing needs of investors, it is becoming increasingly clear that when it comes to measuring and reporting private debt investments, all roads lead to Fair Value.

Historical default rates for Nairobi

Period	Businesses	Retail
Current	0.50%	1.30%
1-30 days past due	1.90%	2.80%
31-60 days past due	3.10%	5.25%
>61 days past d...	7.50%	8.45%