Effects of IFRS 9 implementation on the Kenyan

Financial Services Sector

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Preamble

The International Accounting Standards Board (IASB)'s IFRS 9 standard implementation in January 2018 is widely expected to increase the stock of credit impairment provisions and affect profits.

IFRS 9 will affect...

Credit Losses	Reported credit losses are expected to increase
Classification & measurement	Classification of financial assets becomes more judgmental
Disclosures	Extensive new disclosures are required

Perspective

- IFRS 9 introduces a forward-looking view of credit quality, with banks expected to recognize credit impairment before a loss event.
- IFRS 9 introduces the Expected Credit Loss (ECL) model that replaces the current Incurred Credit Loss (ICL) model under IAS 39

Summary Impairment Stages

Stage 1—as soon as a financial instrument is originated or purchased, 12-month expected credit losses are recognized in profit or loss and a loss allowance is established.

This serves as a proxy for the initial expectations of credit losses.

For financial assets, interest revenue is calculated on the gross carrying amount

Impairment Stages

Stage 2—if the credit risk increases significantly and is not considered low, full lifetime expected credit losses are recognized in profit or loss.

The calculation of interest revenue is the same as for Stage 1.

Stage 3—if the credit risk of a financial asset increases to the point that it is considered creditimpaired, interest revenue is calculated based on the amortised cost (ie the gross carrying amount less the loss allowance).

Financial assets in this stage will generally be assessed individually. Lifetime expected credit losses are recognized on these financial assets.

Impact On Kenya Banking Sector

- Recognition of additional provisions
- Disclosure
- Statutory Loan Loss Reserve
- Transition period

Recognition of additional provisions

Any incremental provisions under the ECL model should be charged to the income statement but the same should be added back over a five-year period for purposes of computing core capital to lower the impact of the additional provisions on core capital during the transition period.

Disclosure

Disclosure: During the transition period, institutions should disclose, in their published results, their core and total capital ratios both before and after the additional expected credit loss provisions have been added back.

Aim: capital position and bottom line.

Statutory Loan Loss Reserve

Where the CBK provisions are higher than IFRS 9, the excess provisions shall be treated as an appropriation of retained earnings and not expenses in determining profit and loss.

Such excess shall be credited to the statutory loan loss reserve as provided in CBK Risk Classification of Assets and Provisioning.

Transition period

CBK proposes five-year transition period during which the incremental provisions may be added back to earnings for purposes of computing core capital.

Expected credit losses to be added back shall be those relating to loans existing and performing as at the end of 2017 and new loansbooked in the year 2018.

SACCOS

SASRA presents the minimum fundamental credit risk management policies and practices that every Sacco is required to have in place.

The guideline outlines the general principles around which more detailed lending procedures and practices should be developed and implemented.

Current Provisions - SASRA

Nature of Arrears	% Provision
Performing loans	1
Watch	5
Substandard	25
Doubtful	50
Loss	100

Non Deposit Taking SACCOS

Previously recognizing members loans based on internal policies will now have to align these policies to the provisions of IFRS 9

Impact on Non Exemption For Performing Debt

- Entities will not be exempted from provision at 1% as per SASRA guidelines

Current Provisions

- The loans and advances by deposit taking SACCOS Stood at Kshs 288.92 Billion in 2016

Risk On Core Capital

Financial soundness and stability of the DT-SACCO system

Capital adequacy, asset quality, earnings and liquidity remains the key criteria for monitoring, evaluating and measuring the financial soundness and stability of the DT-SACCO system.

Current SACCO Capital Position

a) 168 DT-SACCOs were able to fully maintain the prescribed core capital of Kshs 10 Million, with the remaining seven (7) DT-SACCOs failing to maintain the standard.

b) 144 DT-SACCOs were able to fully maintain the prescribed core capital to total assets ratio of 10%, with the rest having ratios of below the prescribed threshold.

c) 169 DT-SACCOs were able to fully maintain the prescribed ratio of core capital to total deposits ratio of 8%, with the rest having ratios of below the prescribed threshold.

d) Only 69 DT-SACCOs were able to maintain and comply with the prescribed institutional capital to total assets ratio of 8%, with the majority of DT-SACCOs failing to comply with this key regulatory minimum.

Consequences On Reduction In Capital Ratios

- prohibition from declaring or paying dividends;
- prohibition from expanding existing activities or engaging in new activities;
- suspension of lending, investment and credit extension operations;

Consequences On Reduction In Capital Ratios

- prohibition from acquiring, through purchase or lease, additional property and equipment;
- prohibition from accepting further deposits or other lines of credit; and
- prohibition from declaring or paying bonuses, salary incentives, severances packages, management fees or reimbursement of expenses to directors or officers.
- Any other action deemed appropriate by the Authority.

Insurance Entities

IFRS 17 is effective for annual reporting periods beginning on or after 1 January 2021. Earlier application is permitted if both IFRS 15 Revenue from Contracts with Customers and IFRS 9 Financial Instruments have also been applied.

Insurance entities have a grace period before manadatory compliance for periods commencing after 2021

Embedded Derivatives In insurance Contracts

IFRS 17 provides the criteria to determine when a non-insurance component is distinct from the host insurance contract.

An entity shall:

Apply IFRS 9 *Financial Instruments* to determine whether there is an embedded derivative to be separated and, if there is, how to account for such a derivative

Embedded Derivative

Separate from a host insurance contract an investment component if, and only if, that investment component is distinct. The entity shall apply IFRS 9 to account for the separated investment component.

Separate any promises to transfer distinct non-insurance goods or services. Such promises are accounted under IFRS 15 Revenue from Contracts with Customers.

Tax Implications

Per the Income Tax Act, increases in general provisions for bad and doubtful debts are considered tax disallowable expenses,

For a debt provision expense to be considered a tax allowable expense, it must satisfy the bad debt guidelines issued by the KRA - specific, and thereby tax allowable, the Commissioner must be satisfied that the debt has become uncollectable after all reasonable steps have been taken to collect it

Tax Implications

- Increased provisions are general in nature this will increase deductible temporary differences thereby increasing deferred tax asset

Impact On Information Technology

IFRS 9 requires impairment models that not only consider past and current events but also future macro-economic information

The standard calls for development of a risk matrix that involves a combination of factors among them the default probability in coming up with ECLs.

This will result in the need to improve on the IT resources to integrate this new requirements

Impact On Dividends

- Dividends will be affected by reduced distributable profits

Impact on Access To Credit

- Increased screening may limit access of funds by SMES
- Credit history will take into account delays in payment of performing loans

General Positive Impact On Financial Sector

Increased financial discipline in lending

Alignment of hedging practice with risk management

Reclassification allows financial entities to provide more realistic disclosures of their financial instruments

End

GOD BLESS YOU ALL