Evidence of Economic Integrity in the Banking Sector: The Adoption of IFRS 9

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Abstract:

This study examines how fair value accounting is applied in the banking sector and how well financial statements generally represent a company's equity value from the standpoint of market valuation. The substantial externalities caused by reporting requirements, such as the effect on third pillar information, further complicate the diverse discussion surrounding this problem, which involves academics, standards setters, and market actors. This study aims to evaluate the value relevance of IFRS 9 implementation in banks and its role in bridging the gap between book and market values of equity, taking into account the societal and economic ramifications covered in the introduction, including the ubiquitous influence of market mechanisms and the critical interaction between market dynamics and contractual tools. Since these businesses' balance sheets can be compared to a security portfolio that is primarily made up of self-generated, illiquid assets, the study suggests that accounting data is considered value relevant when it continues to show an expected correlation with stock market value. A tighter match between the book and market values of equity would indicate that investors view the accounting data as trustworthy and pertinent, supporting this theory.

Introduction:

When it comes to banks and other financial institutions, the idea of market discipline centers on the security holders of the financial firm as the market agents who are responsible for disciplining the firm. The behavior to be disciplined is the risk/return characteristics of the activities that the firm is involved in. Therefore, limiting banks' and other financial firms' excessive risk-taking is the primary goal of market discipline. To a certain degree, ex-ante market discipline is when firms avoid taking on excessive risk; on the other hand, ex-post market discipline is when corporations reverse activities that are too dangerous. In this regard, the necessary initial step of market discipline is the capacity of external parties to keep an eye on a bank's state.

According to the banking literature, banks' propensity to be "opaque," or difficult for investors to understand their asset prices and risk exposures, may hinder market efficiency. The fact that loans, which make up a sizable portion of assets, particularly for commercial banks, are challenging for investors to evaluate is one of the main causes of bank opaqueness. This is mostly because loans, being self-generated financial assets based on private information, are inherently non-negotiable. A potential role for regulators in gathering and disseminating information on bank asset quality may arise from the asymmetry of knowledge between banks and the public regarding the quality of the non-tradable assets that banks hold.

Regulators have been updating the accounting standards over time to enhance banks' accounting quality and lessen bank opacity. The goal of the regulation is to improve banks' accounting standards in order to influence investors' opinions about how well bank financial statements can boost transparency and, indirectly, shareholder value. Policymakers, in turn, are interested in knowing how accounting rules affect the capital market since it helps assess if the reform improves the quality of financial reporting and, consequently, benefits foreign investors.

To enhance the caliber of loan evaluations, the International Accounting Standards Board (IASB) has been updating the accounting standards that govern them. A new expected loss impairment model was adopted by the new International Financial Reporting Standard 9 (IFRS 9) in January 2018, with the goal of promptly assessing the value of loans.

In this paper, we examine the current debate regarding the implications of adopting IFRS for capital markets from a theoretical standpoint and draw attention to the possible repercussions on market discipline. In other words, if market prices accurately reflect the information included in accounting standards. The book value and market value of equity should generally coincide to the degree that the new accounting rules (such IFRS 9) seek to make the balance sheet items more relevant. On the other hand, we wouldn't see an improvement in the alignment between the book value and market value of equity if accounting standards didn't help investors better assess opaque assets. The breach of conventional market assumptions (sometimes known as "market failure") would therefore be supported by this. It is important to note that market discipline has two elements. Investors must first accurately and promptly assess the state of banks. This suggests that investors find the new accounting information beneficial (i.e., accurate) and that they are rational (i.e., arbitrage has no bounds). The second element of market discipline necessitates that investors' responses to the financial circumstances of the bank impact the firm's actions.

IFRS 9

The international accounting standard IAS 39 was released by the International Accounting Standards Committee (IASC) in March 1999. It underwent numerous revisions over time and was ultimately superseded by the International Financial Reporting Standard (IFRS) 9 in 2018. The ongoing expansion of the financial markets and the inherent convolution of banks are the causes of these ongoing additions and modifications. Typically, a single accounting principle

explains the items in the financial statements, but the complexity of financial instruments necessitates the simultaneous and cross-consultation of many accounting principles. The fact that a single concept governs the accounting and recognition of financial instruments for credit and financial institutions as well as for commercial and industrial enterprises contributes to the high degree of complexity. Each of these elements has played a part in creating a complicated rule.

According to the methodology of IAS 39, financial instruments are categorized based on their goals, adhering to the principle that substance is more important than form. As a result, given the contractual nature of a particular financial instrument, a discretionary element was inexorably present in the selection of its purposes. IAS 39's primary goal was to specify the procedures for the first identification and subsequent measurement of the majority of financial instruments. Financial assets were divided into four groups by IAS 39:

(i) Financial Assets at fair value through profits and losses (FVTPL);
(ii) Investments held to maturity (HTM);
(iii) Financial Assets available for sale (AFS);
(iv) Loans and Receivables (L&R).

According to the general criterion, the credit institution was required to measure financial assets, including derivatives that are considered assets, at their fair value after initial recognition. Transaction expenses that might be paid during the sale or disposal of the assets were not to be deducted. Profits and losses were to be used to reflect changes in fair value for the first category, which also included assets held for trading (HFT), while net equity changes had to be used to reflect value differences for the third category. The total profit (or loss) on AFS's financial assets that had been amassed in equity at the time of disposal had to be moved to the income statement's operational income.

The exception to this general rule applied to assets that were categorized as held to maturity, loans, and receivables; these assets were to be valued using the effective interest criterion at amortized cost. An further exemption was granted for investments in equity instruments whose fair value could not be accurately determined and whose market price was not available in an active trading venue; instead, it had to be determined at amortized cost. According to IAS 39, the date of the negotiation or the settlement date could be the first recognition of a financial

asset. All instruments in the same category had to be subject to the same decision. Three criteria were considered in the subsequent valuation: fair value valuation, amortised cost and cost.

IAS 39 states that a financial instrument must only be recognized by an entity when it acquires the rights and responsibilities associated with the financial asset or liability under consideration. The initial recognition in the financial statements is a crucial step that guided the instruments' subsequent evaluation based on two primary factors: the previously assumed position and purpose. All financial assets and liabilities were to be valued fairly at the time of initial recognition, taking transaction costs into account. The sole exception was for financial instruments that fell within the FVTPL category, where the transaction costs were charged straight to the income statement rather than being factored into the instrument's price.

According to the IAS 39 standard, the transaction price—that is, the fair value of the consideration given or received—should typically be equal to the fair value of a financial asset at the time of initial recognition. The classification of assets and liabilities into the various categories during the initial recognition phase was closely related to the criterion that was chosen. When the purpose for which a financial instrument was held changed, IAS 39 permitted the entity to alter the category in which it was recognized.

Financial obligations, on the other hand, were categorized at the moment of initial identification according to their type rather than their intended use. They were classed in relatively few instances since it is uncommon for an instrument to change its nature. Moreover, a financial liability necessarily fell within the FVTPL category only and only at the time of initial recognition.

According to IAS 39, a company must assess and recognize an asset that has lost value at the balance sheet date using the incurred loss method, which only takes into account losses that have actually occurred and ignores anticipated losses. The IASB replaced IAS 39 with the International Financial Reporting Standard (IFRS) 9 because it reduced the comparability of financial statements by delaying the recognition of losses until an excessively advanced stage of the credit cycle and granting excessive discretion in the classification of the same type of financial instrument at the time of initial recognition.

In order to address financial asset categorization and measurement, impairment, and hedging independently, the IASB created IFRS 9 in three stages. The notion that financial assets must be categorized and valued at fair value, which represents their initial cost, is the primary innovation brought about by IFRS 9 for our purposes.

(i) with changes in fair value recognized in the income statement as they occur (FVTPL, Fair Value Through Profit and Loss);

(ii) unless restrictive criteria are met for the classification and valuation of the asset at amortized cost (AC);

(iii) at fair value recognized in the other components of the comprehensive income statement (FVTOCI, Fair Value Through Other Comprehensive Income) which impact on the shareholders' net equity.

In order to better align the accounting representation with the financial markets' valuation perspective and in line with the associated interpretation of the bank as a portfolio of financial assets, the discounted cash-flow methodology serves as the foundation for the fair value and associated subsidiary criteria. As a result, under IFRS 9, the basis for measuring assets is based on their classification, whereas under IAS 39, the opposite was true, with the basis for measurement typically being decided by the manner assets are categorized. In turn, the business model that underpins the financial investment and the contractual cash flows of each asset provide the value criteria that will be used in a two-step process.

For the most part, the business model refers to the management objective of investing in financial assets, which essentially results in their classification into three categories: (i) financial assets acquired for the purpose of collecting contractual cash-flows; (ii) financial assets held for both trading and collecting expected cash-flows; and (iii) financial assets acquired for trading or for other purposes. If financial assets are kept for purposes other than those listed in categories (i) and (ii), they are recognized at fair value through profit and loss, ignoring the fair value option to eliminate discrepancies in accounting treatment. In order to confirm the contractual features of the other categories, IFRS 9 asks that the so-called SPPI test be applied as a second step.

To put it simply, if the contractual flows consist solely of principal and interest payments, then (i) assets are evaluated at fair value using the other comprehensive income, and (ii) assets are recognized at amortized cost by computing their implicit effective yield, such as for loans. The FVTPL is applicable if the contractual cash flows are different from capital payments and pure interest. Financial intermediaries must thus create sufficient internal policies and processes for the accurate evaluation of business models that are suitably connected to risk management and governance. Each asset must have its contractual characteristics analyzed at the moment of its initial recognition in the business model, as opposed to the identification of the business model, which must be done at a higher level of asset aggregation.

The appropriate and prompt recognition of value adjustments of loans (impairment), in connection with the relative deterioration of their credit quality, is the second nodal problem of intervention by the new accounting standard. In this regard, the "forward looking" approach introduced by IFRS 9 allows for the preventive quantification of losses based on the anticipated losses that define the banking industry. Compared to the prior premise, which was primarily based on identifying a trigger event that could deteriorate the debtor's creditworthiness, this change in approach seems to be of utmost importance.

Financial intermediaries are asked by the IFRS 9 impairment model to divide the loan portfolio into three categories (stages) based on credit quality: performing loans (stage 1), non- performing credits (stage 3), and the introduction of an intermediate classification (stage 2) for underperforming debtors (stage 2). The important aspect is that, depending on how much the credit risk of the existing financial assets has deteriorated, IFRS 9 asks that the possible credit losses embedded in the loan portfolio be taken into account right away. More specifically, the accounting framework now allows for the evaluation of value adjustments that take into account the likelihood of default through the use of (i) probability of default, (ii) loss given default, and (iii) exposure at default computed over the course of the credit's full residual life for underperforming (stage 2) or non-performing or defaulted (stage 3) exposures, or the period of 12 months for fully performing loans (classified in stage 1). All exposures experiencing a substantial decline in credit compared to their prior

recognition and falling into high-risk rating categories are considered underperforming loans. According to such viewpoint, a marginal predicted loss that must be accounted for will always be present in performing loans as well.

Since the expected losses represent the management's expectations regarding potential challenges in collecting contractual cash flows, this approach is essential to the sector's financial stability because it allows for the estimation of expected losses and related provisions, which must be updated at each reporting date to reflect changes in credit risk. From the perspective of the efficiency and efficacy of the methodology for the expected estimate compared to the past, the use of the expected loss results in an improvement in risk management and, consequently, a better emphasis on risk management.

Furthermore, financial crises are more likely to occur for institutions that acknowledge losses later in a downturn than for those that do so sooner. This will lessen the volatility of balance sheet items by enabling banks to maximize their contraction during recessions and boost their equity during expansions. Consequently, more data is presented to help analysts and investors with the qualitative and quantitative evaluation of anticipated credit losses. In order to achieve this, institutions will have to supply essential data that is essential to calculating the anticipated losses for every kind of instrument.

Because the financial statements of banks with high-risk, loss-free, and highly profitable financial instruments could not be compared to those of intermediaries with low-risk financial instruments that do not honestly disclose the credit risk, the previous accounting standard created an excessive amount of discretion. Furthermore, the financial crisis experience shown that the incurred loss model was unsuitable for safeguarding the banking industry's macroeconomic and microeconomic stability, especially when taking into account the accrued loss perspective's strong pro-cyclical inclination.

Due to the modifications made to the impairment model, which, as we all know, has evolved into expected loss with a "forward looking" vision, replacing the incurred loss, the new accounting standard will have a greater impact on the financial statements of banking institutions, according to studies done by the European Banking Authority (EBA) beginning in 2018. In particular, banks will have to calculate larger provisions under the

new accounting standard, particularly when it comes to performing loans. Banking institutions will no longer need to differentiate between non-performing and performing loans as a result of the implementation of IFRS 9, which requires them to enhance the provision for performing loans as well. Because the provision was determined using portfolios comprising many financial instruments and taking into account the anticipated losses over a 12-month period, the impact of performing loans under IAS 39 was negligible. If they have demonstrated an increase in credit risk, the new standard will calculate the provisions for each individual loan and determine the expected loss based on the residual life of each loan. As a result, the provisions for this type of credit will increase.

Conclusion

This paper had two objectives. First, we sought to determine how much the implementation of IFRS 9 enhanced the evaluation of banks' equity book value. Our second goal was to ascertain how the market would react to the implementation of this novel accounting concept.

Following its adoption in 2018, the market value of equity should react if the market thinks that IFRS 9 improves the trustworthiness of banks' financial statements. This would improve the evaluation of the market value of banks' equity. A lack of market reaction, on the other hand, would be consistent with the following potential outcomes: (i) the market's "failure" to incorporate useful information into prices, or (ii) the market's perception that the new information brought about by IFRS 9 is not valuable enough to be incorporated into their beliefs. This would be the case, for example, if investors' capacity to value opaque assets (such loans) is not enhanced by the new accounting norms. If this happens, there will be a "failure" of the international accounting rules rather than a "market failure."

By improving the financial statements' capacity to accurately depict the true worth of shareholders' equity, IFRS 9 has given investors access to new and useful information. The primary vision has actually changed from a model based on the destination that management attributes to a single instrument (IAS 39) to one based on the economic activity management method (IFRS 9). This is because a new model for the valuation of expected losses has been introduced that allows for a more future-oriented valuation.

By directly controlling the valuation of loans, a significant asset component for commercial banks, the new regulatory standard has made it feasible to reduce the opacity that defines bank assets.

The primary conclusions of the body of research in finance indicate that IFRS 9 has increased investor confidence by improving the report's dependability with regard to the bank's loan portfolio. More comparability has also been created for foreign investors as a result of the decrease of information asymmetries, which has raised the significance of book values when making investment decisions. Consequently, the idea of a "market failure" in response to the implementation of IFRS 9 is not supported by the empirical evidence.

It should be noted that current research in this area of the literature focuses on how equity values (i.e., prices and returns) react. However, we think that comparing book values to market values of shareholders' equity would allow for a more direct test of "market failure or discipline." Future studies in this area should look into whether the book value and market value of equity are more accurately aligned under the new international accounting standard, IFRS 9, than they were previously.

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