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المجلس العام للبنوك والمؤسسات المالية الإسلامية

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CIBAFI BRIEFING

The International Financial Reporting Standard (IFRS) 9 and its Implications on Islamic Financial Institutions (IFIs)

CIBAFI is pleased to present its tenth "CIBAFI Briefing" on the impact of the implementation of IFRS 9 on Islamic financial institutions. This briefing presents an overview of IFRS 9 and its new requirements regarding impairment, classification and measurement of financial assets and liabilities, and hedge accounting. This briefing will evaluate the impact of IFRS 9 on Islamic banks through a short survey conducted by CIBAFI, present the key areas affected by the implementation of the standard, and suggest key recommendations for a smoother adoption of future standards.

1. Introduction and Background

Accounting standards are a set of principles that organisations follow when they prepare and publish their financial statements, providing a standardised way of describing the company's financial performance and helping investors in their decision-making process. The International Financial Reporting Standards (IFRS), issued by the International Accounting Standards Board (IASB), is the most widely-used set of standards in more than 166 jurisdictions all over the world. Several jurisdictions that have Islamic Financial Institutions (IFIs) have adopted these standards even though they do not meet totally the specificities of Islamic finance transactions. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) aims to produce standards based on IFRS while catering to the unique characteristics of the operations of IFIs; these are the Financial Accounting Standards (FAS). IASB has a consultative group, established in 2011 and now called the Islamic Finance Consultative Group, to consider the challenges posed by applying IFRS to Islamic finance. CIBAFI is member of this group.

IFRS 9, issued in 2014, is the IASB's standard on financial instruments, replacing the earlier standard IAS 39. IFRS 9 introduces a forward-looking model for losses and impairment expectations; a new approach for classification and measurement of financial assets; and a new hedging model. IFRS 9 is, in principle, mandatory for annual periods starting from 1st January 2018 and beyond, with early application permitted. However, some jurisdictions have introduced IFRS 9, but with plans for a later application date.

AAOIFI has revised several of its standards in response to IFRS 9. The most important revisions are in FAS 30, which introduces a forward-looking model for losses and impairment broadly similar to that of IFRS 9 (replacing the relevant parts of FAS 11). However, FAS 25[1] and FAS 35[2] are also relevant.

Some jurisdictions require Islamic banks in their territories to account under IFRS. Others require them to account under AAOIFI standards, in some cases with IFRS as a fall-back for topics not covered by AAOIFI. Others still have their own national standards, though these may draw heavily on either IFRS or AAOIFI standards. Whichever approach is taken, it is common, though not universal, for banking regulators to give more detailed advice on the application of the relevant standard.

2. Implications of IFRS 9 for Islamic banks

The application of IFRS 9 in several jurisdictions poses a few challenges to Islamic banks. The new standard aims to bring more transparency, accountability and efficiency to financial markets across the globe through streamlined, high-quality accounting criteria. Thus, where applied, IFRS 9 presents a challenge to Islamic banks, particularly in weak regulatory environments, in their need to adapt their reporting to the new requirements introduced. This mainly affects the following areas:

- Impairment;
- Classification and measurement of financial assets and liabilities; and
- Hedge accounting.

2.1. Expected Credit Loss Model and the New Model's Implications

IFRS 9 introduces a new model of impairment for faster and fuller recognition of expected credit losses (ECLs) based on the historical events, current condition and forecast information. The new impairment model requires impairment allowances for all exposures from the time a loan is originated, based on the deterioration of credit risk since initial recognition. The model uses a three-stage approach to determine the ECLs: if the credit risk has not increased significantly (Stage 1), IFRS 9 requires allowances based on 12 month expected losses; however, if the credit risk has increased significantly (Stage 2) or if the loan is 'credit impaired' (Stage 3), the standard requires allowances based on lifetime expected losses. FAS 30 introduces a broadly similar approach.

This model of impairment is expected, in general, to result in higher credit loss provisions for financial institutions. It also presents several challenges to financial institutions, including:

- Possible problems in terms of the required amendments to systems and processes; and
- Lack of available and quality data: institutions need a large amount of historical, current and forward-looking data to build a model upon which judgements for expected losses can be based.

2.2. Classification and Reporting of Financial Assets under IFRS 9 and FAS 25

Under IFRS 9, financial assets are classified into three categories according to the business model and contractual characteristics of the cash flows associated with the assets: i. assets measured at amortised cost; ii. assets valued at fair value through other comprehensive income; and iii. assets valued at the fair value through income statement.

The corresponding AAOIFI classification for investments is found in FAS 25, where the terminology is: i. Investments measured at amortised cost; ii investments measured at fair value through equity; and iii investments measured at fair value through income statement. In both standards, however, banks initially identified some difficulties in classifying some of the instruments of Islamic finance, especially hybrid contracts.

1. AAOIFI Financial Accounting Standard No. 25: "Investment in Sukuk, shares and similar instruments"
2. AAOIFI Financial Accounting Standard No. 30: "Impairment, credit losses and onerous commitments"

2.3. Hedge Accounting Model Requirements under IFRS 9

IFRS 9 improves the decision-usefulness of financial statements by better aligning hedge accounting with the risk management activities of an entity. If certain eligibility and qualification requirements are met, hedge accounting allows an entity to match gains or losses on financial hedging instruments with losses or gains on the risk exposures they hedge. There are some differences in hedge accounting between IAS 39 and IFRS 9, but the hedge accounting continues to be optional. Because of the very limited Shariah-compliant hedging instruments available, it is unlikely that these provisions will be used much by Islamic banks.

3. Islamic Banks' concerns and the CIBAFI survey

There had been considerable concern about IFRS 9 on the part of both banks and regulators in the run-up to its implementation. In June 2018, the Islamic Financial Services Board (IFSB) published in its annual Stability Report a survey of regulators on the impact of IFRS 9, conducted in mid-2017[3]. Although only two regulators were able to offer quantitative data on the expected impact on Islamic banks, overall, the respondents identified several areas of high concern to them, as well as to Islamic and conventional banks in their jurisdictions. These concerns revolved particularly around the availability of data and resources to compute ECL provisions, highlighting the development of an ECL model as a complex process and emphasising that smaller banks are set to face more challenges in comparison to bigger banks. CIBAFI had also various concerns from its members about how IFRS 9 might impact on them.

CIBAFI decided that it might be helpful to survey Islamic banks' actual experience in the early implementation of IFRS 9, in part to see whether earlier concerns had been confirmed.

It therefore conducted a short survey of 13 selected Islamic banks across a range of jurisdictions. The survey was conducted in mid-2018.

The jurisdictions included some financial institutions which had implemented IFRS 9, in succession to IAS 39, and some which had implemented, or were implementing, its AAOIFI counterparts. One jurisdiction had, as yet, implemented neither, and one jurisdiction with its own standards had nevertheless required banks to use IFRS 9 from 2019. No jurisdiction had required banks having previously used AAOIFI standards to use IFRS 9, or vice versa, except one which had required the use of IFRS 9 as an interim measure while it prepared implementation guidance for FAS 30. This implies that it considered the differences between the two relatively small, a view reinforced by the fact that some banks in jurisdictions where AAOIFI standards are mandated nevertheless reported themselves as implementing IFRS 9.

Because of the relatively small number of banks surveyed, the sample cannot be seen as statistically representative. In addition, while some banks were well into the process of implementing IFRS 9 or its AAOIFI counterparts, others had not yet begun. They are therefore responding from different situations. For these reasons, the results are in general presented in narrative rather than statistical form, but they are nevertheless highly informative.

4. Survey results

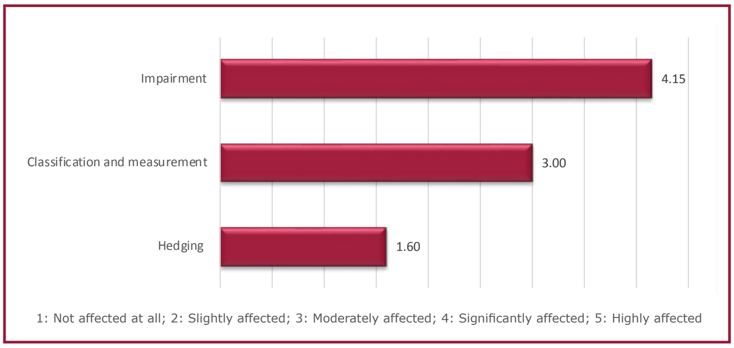
The survey aimed to evaluate the impact of IFRS 9 on Islamic banks. In general, banks were asked about the challenges faced in IFRS 9 implementation; the effect of IFRS 9 and the new impairment model on Islamic banks' balance sheets, capital adequacies, collateralization, and products & services; as well as on any Shariah issues faced in the implementation of IFRS 9.

The survey comprised both "closed" and "open-ended" questions. The open-ended questions were intended to enable industry leaders to express their views in the most effective and detailed way, while the closed questions aimed to evaluate the influence of IFRS 9 on Islamic banks regarding certain aspects. For the latter, a scale from 1 to 5 was usually used, where 1 refers to no impact/effect, while 5 refers to high impact/effect.

4.1. Balance Sheet Impacts

When the banks surveyed were asked which aspect of balance sheet accounting they thought would be most affected from the implementation of IFRS 9, impairment clearly came top of the list with an average score of 4.15, showing that the majority of the banks are expecting the top level of impact. A moderate level of impact was expected in the area of classification and measurement, with an average score of 3; however, most banks expected no impact at all on hedging, with some of them expressly citing the lack of Shariah-compliant hedging instruments. This is broadly in accordance with prior expectations.

Figure 1: Impact of the Implementation of IFRS 9 on the Balance Sheet of Islamic Banks



Source: CIBAFI

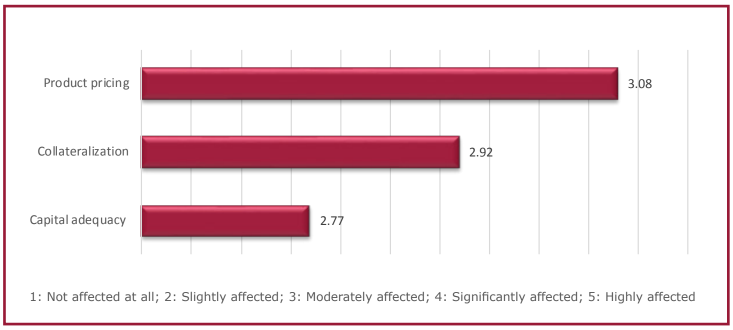
3. Islamic Financial Services Industry Stability Report 2018, section 2.2.3.2.

4.2. Impairment Methodology

A further question asked specifically about the scale of the impact from the changes in impairment accounting, measured by the increase in provisions between 2017 and 2018. Of the banks that had made estimates, 5 expected either a decrease or an increase of less than 5%, one expected an increase of 5-10%, one 10-20%, one 20-30% and three expected more than 30%. One of these, however, was in a jurisdiction where IFRS 9 is not yet required.

We also asked about the extent to which the new impairment methodology would impact the bank's capital adequacy, product pricing or collateralization. In general, Islamic banks expected a low to moderate impact on each of these, with two outliers expecting the highest level of impact in each area. One of these also expected a high level of impact on profitability, taxation policy and dividend policy – but, interestingly, this bank is in a jurisdiction that has not yet mandated IFRS 9 (or its AAOIFI counterpart).

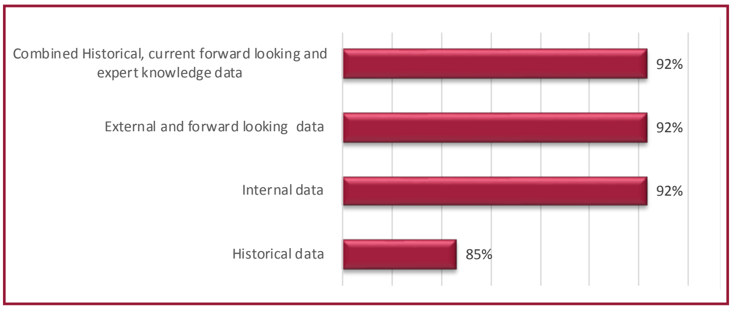
Figure 2: Impact of the New Impairment Methodology of IFRS 9 on Islamic Banks



Source: CIBAFI

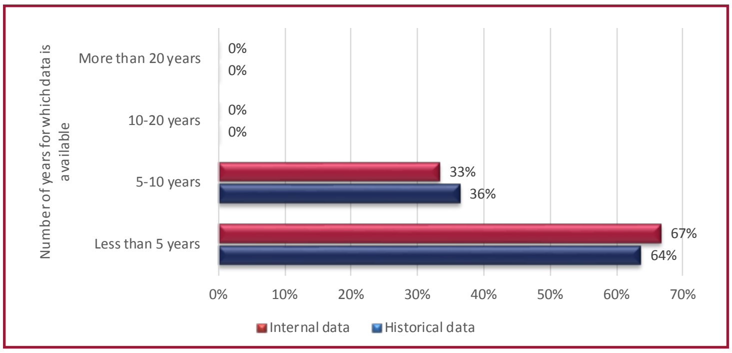
When asked what data the banks would use to build their new impairment model, all but one expected to use historical data; however, eight of these twelve had data for less than five years, and none of them had data for more than ten years. Banks also expected to use external and forward-looking data, mainly relevant macroeconomic information and analysis. Only half expected to use the bank's own forward view of future economic conditions. These responses suggest that some banks will struggle with both data availability and the necessary analytical capability.

Figure 3: Type of Data Used to Build the New Impairment Model



Source: CIBAFI

Figure 4: Availability of Internal and Historical Data within Islamic Banks

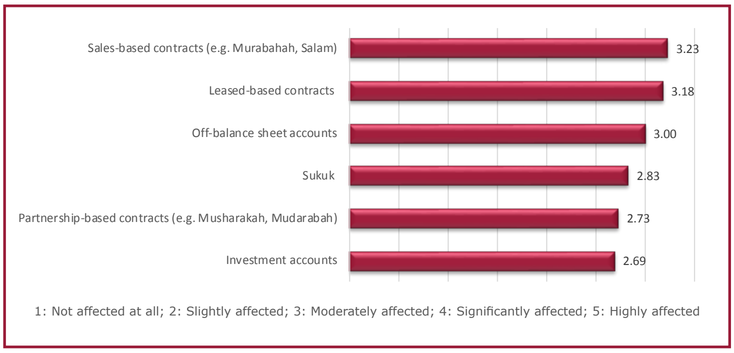


Source: CIBAFI

4.3. Islamic Contracts and Shariah Issues

We asked specifically about the impact of IFRS 9 on the particular Islamic financial products and services. In general, Islamic banks expected slight impact on investment accounts, partnership-based contracts such as Musharakah and Mudarabah, Sukuk and moderate impact on off-balance sheet accounts. The picture was more mixed between moderate to significant impact for lease-based contracts such as Ijarah, and for sales-based contracts such as Murabahah and Salam. Two banks, however, expected the highest level of impact in essentially every category, with a third only just behind them. Of these three, one is in a jurisdiction that has not yet mandated IFRS 9; and one is in a jurisdiction where the Central Bank has a record of specifying the calculation of provisions in a way very different from IFRS 9, and was still issuing new guidance at roughly the time of the survey. This indicates that the issues here may be jurisdiction-specific.

Figure 5: Impact of IFRS 9 on Islamic Financial Products



Source: CIBAFI

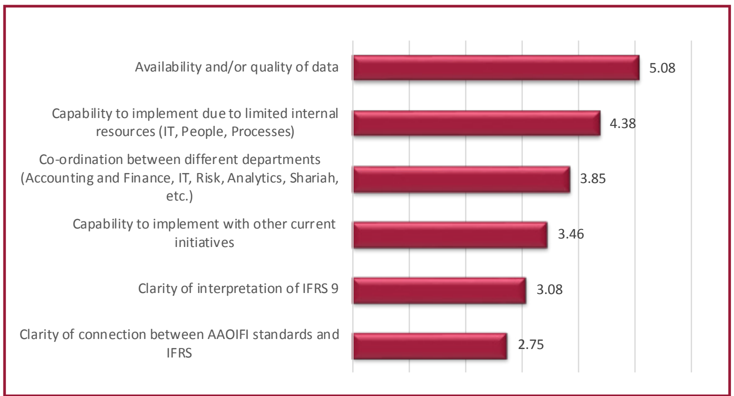
We also asked about any Shariah issues raised by IFRS 9. Some of the banks were in fact applying the AAOIFI counterparts, so unsurprisingly found no Shariah issues. In other cases, survey comments revealed that banks were using AAOIFI standards, or guidance from their own regulators, to resolve any possible ambiguities, even when applying IFRS 9.

In fact, no Islamic bank identified any Shariah issues in the implementation of IFRS 9.

4.4.Challenges and Influences in Implementation

We asked Islamic banks to rank the challenges involved in implementing IFRS 9 in their own situation from 1 (least important) to 6 (most important). There was a wide spread of responses, but the clear leader overall was the availability and quality of data with a score of 5.08, followed by limited internal resources, co-ordination between departments, and ability to implement along with other initiatives. All of these were more important than clarity of IFRS 9's interpretation or the relationship between IFRS and AAOIFI standards.

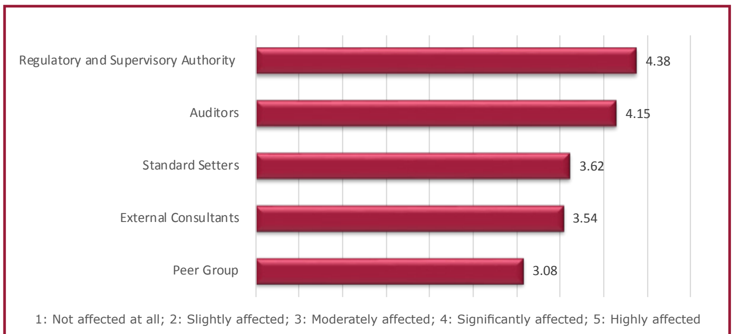
Figure 6: Challenges in the Implementation of IFRS 9 in Islamic Banks (1: least important & 6: most important)



Source: CIBAFI

When we asked which bodies would be most important in providing interpretation for the implementation of IFRS 9 in the jurisdiction, the regulatory and supervisory authority clearly stood out ahead of standard-setters, auditors and external consultants, with the bank's peer group in last place. This is supported by some of the write-in comments, which emphasize strongly the role of the central bank or other regulator.

Figure 7: Bodies Influencing the Interpretation and Implementation of IFRS 9 within Islamic Banks



Source: CIBAFI

5. Conclusion and Recommendations

Overall, the pattern that seems to be emerging from this limited survey is that, although the implementation of IFRS 9 and its AAOIFI counterparts has proved challenging for many Islamic banks, some of the worst fears have not been realised. For most banks, the impacts on key balance sheet figures, though material, seem to be at levels that would be manageable. The responses in this area are, however, quite variable, and sometimes differ significantly even between banks in the same jurisdiction. This suggests that idiosyncratic factors are at work, and regulatory and supervisory authorities will need to be alert for any banks that are hit particularly hard.

With regards to the interpretation of the standard, banks appear very reliant on guidance from their regulators, in contrast with the situation in many Western countries where banks rely more on their own resources or those of accountancy advisers. As a result, where the regulatory or supervisory authority gives clear guidance, banks are content to follow it and therefore have few difficulties of interpretation. The jurisdictions where interpretation has been a problem for some banks seem to be largely ones where guidance had not been forthcoming at the time of the survey, or where their relationship to other regulatory guidance still needed to be resolved. Regulatory and supervisory authorities therefore need to continue to support their industries with guidance, and to engage with them to understand where they are meeting difficulties. Conversely, financial institutions, especially those where IFRS 9 is still to be fully implemented, must be proactive in their interpretation and implementation and not wait for regulators to issue further guidance. For that purpose, they may need to use consultants, experts or audit and accounting firms.

Islamic banks identified no Shariah-related issues with IFRS 9. In some cases, this was because they were in fact using its AAOIFI counterparts; in others, because they relied on their regulatory or supervisory authority to have resolved these when giving guidance. In at least one case, it appeared that the bank was actually using AAOIFI standards to guide its interpretation of IFRS 9.

Implementation of IFRS 9 is nevertheless proving organisationally challenging. The challenges appear to be mainly concerned with the new impairment rules, and the need to build expected credit loss models. Banks, which may have been used to following mechanical rules in this area, are finding that the building of models is technically challenging and requires cross-organisational working which may itself be difficult. In addition, they often do not have the long data series needed as inputs to these models, and the internal economic skills to create or use forward-looking information. While there is little that can be done to support those banks that are already implementing IFRS 9, those banks for whom this is still in the future should ensure that there are adequate resources to support it, especially in the areas of modelling and economic analysis, and that they are already creating the data series that will be necessary to feed the models.

In addition, the issues that Islamic banks have encountered and are still facing in implementing IFRS 9 may be taken into consideration for the revision of upcoming standards such as IFRS 17 on 'Insurance Contracts'. IFRS 17, issued in May 2017, replaces IFRS 4 to provide additional and amended requirements for consistent accounting principles for insurance contracts and will be effective for annual periods starting from 1st January 2021. As insurance companies are preparing themselves for the new accounting standard, Takaful companies are facing significant uncertainty in how to interpret and apply the new standard to their business. IFRS 17 was developed largely based on conventional insurance structures, which makes its implementation by Takaful companies not very straightforward. Thus, before its implementation in 2022, the Islamic financial industry practitioners, actors and Regulatory and Supervisory Authorities (RSAs) are encouraged to do further research, open debates and highlight issues that may be challenging for Takaful companies in applying IFRS 17. This will help to mitigate future problems, such as defining the data that should be collected in order to report under IFRS 17, and integrating any IFIs' specificities within the standard for a comprehensive global accounting framework for insurance contracts. Furthermore, AAOIFI should plan to complete any changes to its own insurance standards by no later than mid-2020, so that they can be implemented in parallel with IFRS 17 and with reasonable time for preparation.

Acknowledgments

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About CIBAFI

CIBAFI is an international organization established in 2001 and Headquartered in the Kingdom of Bahrain. CIBAFI is affiliated with the Organization of Islamic Cooperation (OIC). CIBAFI represents the Islamic financial services industry globally, defending and promoting its role, consolidating co-operation among its members, and with other institutions with similar interests and objectives. With over 125 members from more than 34 jurisdictions, representing Islamic Banks, market players, international intergovernmental organizations and professional firms, and industry associations, CIBAFI is recognised as a key piece in the international architecture of Islamic finance. In its mission to support Islamic financial services industry by being the leading industry voice advocating regulatory, financial and economic policies that are in the broad interest of our members and that foster the development of the Islamic financial services industry and sound industry practices, CIBAFI is guided by its Strategic Objectives, which are 1. Policy, Regulatory Advocacy, 2. Research and Publications, 3. Awareness and information sharing and 4. Professional Development.

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