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THE 12th ANNUAL AOSSG MEETING

Joining hands in regional cooperation and the development of IFRS

November 23-25, 2020, Virtual Meeting

The Challenges in Implementing IFRS 9 in Brunei

BY THE BRUNEI ASSOCIATION OF BANKS FINANCE COMMITTEE

Tan Pheng Leong
Chief Financial Officer
Bank Islam Brunei Darussalam

Background to IFRS 9 Adoption in Brunei

- 4 years after Brunei's Initial Adoption of IFRS
- IFRS used by Public Interest Entities only

1. **Timeline for the adoption**
   - The International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB) was successful adopted by public interest entities such as Banks and Insurance / Takaful companies in Brunei on **1 January 2014**.
   - The adoption of IFRS 9 was by **1 January 2018** with the first set of financial statements based on IFRS 9 for the financial year ended 31 December 2018 published by 31 March 2019.
   - This was a tight timeline as Brunei banks converted from Brunei GAAP to IFRS only from financial year ended 31 December 2014.
   - For Insurance and Takaful companies ("NBFI"), adoption of IFRS 9 can coincide with IFRS 17 Insurance Contracts by 1 January 2023.

2. **The following slides sets out the BAB-Finance Committee experience and challenges faced in the adoption of IFRS 9 and also post implementation.**

A Recap of Key Areas of IFRS 9

Key Areas	Challenges
1. Classification and measurement of financial assets	• Identification of Solely for Principle and Profit/Interest (SPPI) assets and Business Models test for Amortized Cost and FVOCI. E.g. Bonds and Sukuks in Treasury portfolio. • Non-Bifurcation of assets with embedded derivatives • Valuation of assets under FVOCI and FVTPL* * Not necessarily a challenge created specifically by IFRS 9 but due IFRS 13 *Fair Value Measurement*
2. Impairment	• Staging. Identification and assessment to determine if assets is ➢ Stage 1: 1 Year ECL ➢ Stage 2: Life time ECL ➢ Stage 3: Impaired or Non-Performing • Computation of ECL (see next slides)
3. Hedging	• Hedge documentation and testing albeit less complex than in the past under IAS 39.

Key Approaches to IFRS 9 Adoption

1. **Approaches by Bank**
   - The extend of impact varies across banks.
   - In summary, for banks in Brunei, the typical approaches are to engage consultant or leverage on head offices for knowledge transfer.

2. **Areas of IFRS 9 where banks focused on**
   - Classification of financial instruments into Stage 1, 2 and 3. Banks used a mixture of judgement and day pass dues.
   - Impairment are either model based collective using PD, LGD and EAD or specific impairment. There is a need to establish lifetime PD for Stage 2.
   - Valuation of financial assets. Some complex investments were previously bifurcated into underlying assets and derivatives. These will need to be valued as a single instrument.
   - Hedging are of limited impact to banks in Brunei.

- Use of Consultants and/or Head Office Support for **Knowledge Transfers**

- Extensive Use of **Judgements** by Risk Management and Finance Teams

Challenges of Initial IFRS 9 Adoption

Data Systems & Capabilities

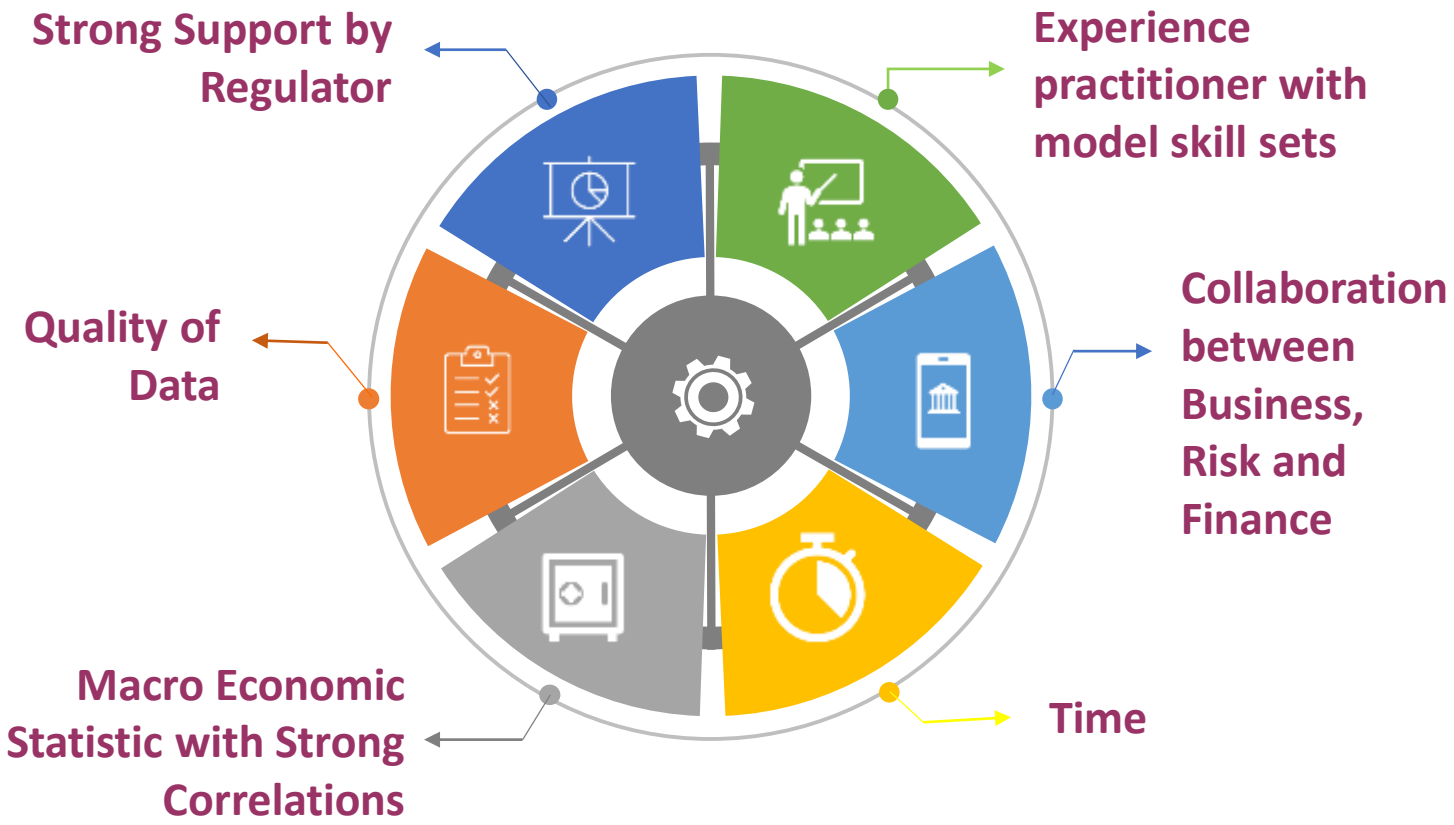
Population size of small portfolios

Proxy Data for External Rating PDs & LGDs

1. **Enhancements to data systems and capabilities to accommodate extensive data requirements of the IFRS 9 standard**
   - The standards requires significant amount of data to form a historical data set for analysis. This requires enhancements to existing data systems.
   - Certain data required may not be captured in the past and thus require data gathering retrospectively.

2. **Availability of reliable data of sufficient population size**
   - In general, for medium/small sized economies, there may be a lack of sufficient country specific loss rate historic data, in order to create the loss rate and expected loss curves for the various portfolios and products.
   - Certain product have limited data to produce statistically strong numbers for Probability of Default (PD) or Loss Given Default (LGD). For banks that were newly startup or for new products, there may not be sufficient historical population size to formulate a quality statistical historical data set.
   - Proxies were required. This could mean using overseas historical data (in the case of international banks) or reliant on external rating agencies data sets which may not be Brunei specific.
   - Further challenges from using external data set was the need to map external ratings to the bank's internal rating system.

Challenges on Adoption & Post Implementation



Challenges on Adoption & Post Implementation (Cont'd)

Strong Support by Regulator

Macro Economic Statistic with Strong Correlations

Experience practitioner

- **Strong Support by Regulator**
  - The success of the initial adoption was a result of an open communication with and positive support provided by the Regulator to the Banks during the adoption.
  - Clarification and understanding of the interaction between the IFRS 9 standards and the regulatory standards resulted in regulatory and IFRS standards alignment.
- **Macro Economic Statistic with Strong Correlations**
  - IFRS 9 requires a macro economic overlay. There was a need to study correlation between industry / segment of customer to economic data to arrive at such an overlay.
  - Statistics such as property price index or unemployment rate were available for more recent history only and may not produce strong relationships to default history.
  - Long term economic forecast data are available for Brunei from number of sources such as IMF or ADB. There is still a need to develop economic forecast capability by individual companies or banks.
- **Availability of technical accountant and experienced credit practitioner**
  - IFRS 9 requires Finance to work closely with Credit Risk department due to the nature of the standard. As IFRS in general was relatively new in Brunei, the hiring of experienced accounting talent and credit practitioner who understood IFRS 9 was a significant challenge.
  - While the pool of experience practitioner has since increased by 2020, this remain a small pool and further professional developments required as the ongoing use of IFRS 9 does introduce additional challenges such as model validation.

Challenges on Adoption & Post Implementation (Cont'd)

Model skill sets

Quality of Data

Time

- **Model skill sets to validate ECL model**
  - Once the IFRS 9 ECL models were established, banks are required to regularly validate the models' relationship, output and outcome to ensure quality and compliance with IFRS 9.
  - The need to develop skill sets for model validation remains a challenge for Banks and this also added additional work to the Finance and Risk teams on an on going basis.

- **Quality of Data such as financial statements**
  - In the past, Brunei corporates did not have a common accounting standards but was based on accounting practices. However, the launch of Brunei Darussalam Accounting Standards (BDAC) will address the lack of common standards from 1 January 2018.
  - Quality and timely financial statements remain a key input into the rating of companies which in turn, was a data point to determine the corporates IFRS 9 level (in particular, to determine if a Company was stage 1 or stage 2).

- **Time to operationalize IFRS 9**
  - Setting out accounting manual, internal reporting KPI, budgeting and other management reports will require time to be operationalized.

Other specific banking sector related challenges

1. **Regulatory returns were updated for IFRS 9**
   - Other than adopting IFRS 9 for financial reporting, banks were required to submit new and updated regulator reporting based on IFRS 9 to the banking regulators. This puts further time pressure on an already stretch finance teams and infrastructure as a result of adopting IFRS 9.
   - A good practice by the regulator was to launch new returns and parallel run this existing returns. Close coordination and understanding between the sector and the regulator was important to ensure success of the parallel run and the eventual rolling off the old returns.

2. **Impact of IFRS 9 on Non Performing Financing / Loans (NPF) and front end cultural changes**
   - Regulatory NPF definition has been expanded to include IFRS 9 stage 3 whereas in the past, it was based on day past due which under IFRS 9 is a back stop.
   - As NPF is a key performance measure for banks, a further need to educate front end and risk management teams on the implication of IFRS 9.

CHALLENGES OF IFRS 9 FROM THE PENDEMIC

1. Impact of economic support and significant increase in risk (SICR)

- **Technical assessment required to consider the impact of Covid 19 on credit risk, the effect of economic support and relief measures provided.**
- Assessment conducted to determine impact on classification of financing stages (1 vs 2), modification and/or derecognition for financial instruments.
- Additional disclosures may be required as well for both qualitative and quantitative impact.

2. Model robustness

- Covid 19 introduced a high level of uncertainty and a sudden change in the economic environment. This shock to the system meant that existing models may not be as robust or predictive.
- Models were generally build based on 3 to 5 year of historical data. **The Covid 19 situation in 2020 may result in a challenge for the predictive ability of the models** since the data set may not have sufficient shocks similar to that of Covid 19.
- The forward looking nature of IFRS 9 and the macro economic adjustments further introduced challenges due to the need for timely information in the current context such as economic forecasts.
- Discussions on out of model adjustments **to address the uncertainties which adds further judgements and technical challenges.**

THANK YOU