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THE IMPORTANCE OF IFRS 9 WITHIN ROMANIAN BANKING SECTOR AND THE SECURITIZATION OF BANK ASSETS

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Abstract

International financial reporting standards and especially the new IFRS 9 standard represents a important change in the business model of the banking sector because moving from a incurred credit loss model to an expected credit loss model translates into fundamentally changing the provisioning g methodology In this paper we aim to answer the question from what's the probability that a default has occurred to what's the probability that a default will occur, to highlight the importance of understanding securitization of banking assets. The economic and financial crisis demonstrated the importance of regulation in the banking sector, regulations which can lead to a better management of risks, balance between loans and deposits and many more. The securitization of banking assets represents a financial innovation which has a long history in the capital markets. IFRS 9 represents the biggest accounting change in the last years in accounting.

Keyword: IFRS 9, IAS, assets, securitization, regulation, liquidity, cash flow

JEL Classification: M40

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I. Introduction

For the banking industry in Romania the implementation of the new International financial reporting standards will need to figure out a number of key decisions. Among these decisions is how will the banks quantify the expected credit loss, how to figure out what is a significant increase in credit risk.

The IFRS 9 implementation in Romanian banking sector means that stakeholders need to assemble all key aspects in their banks such as accounting, credit, capital, data modelling in order to come up with a practical solution

Securing assets involves changing the traditional balance sheet assets traded in the market, such as a loan, in marketable securities and move them off balance. When the assets of a bank are secured, the different functions of traditional bank lending are separated.

We could define securitization as the conversion of receivables and cash flow generated from a portfolio of financial assets such as mortgage loans, auto loans, credit card receivables and others into the marketable securities.

II. Financial Instruments for the Banking Industry

The new model of classifying financial assets is based upon the determination of the business model for retaining the financial asset and the determination of the contraction cash flows of the financial asset.

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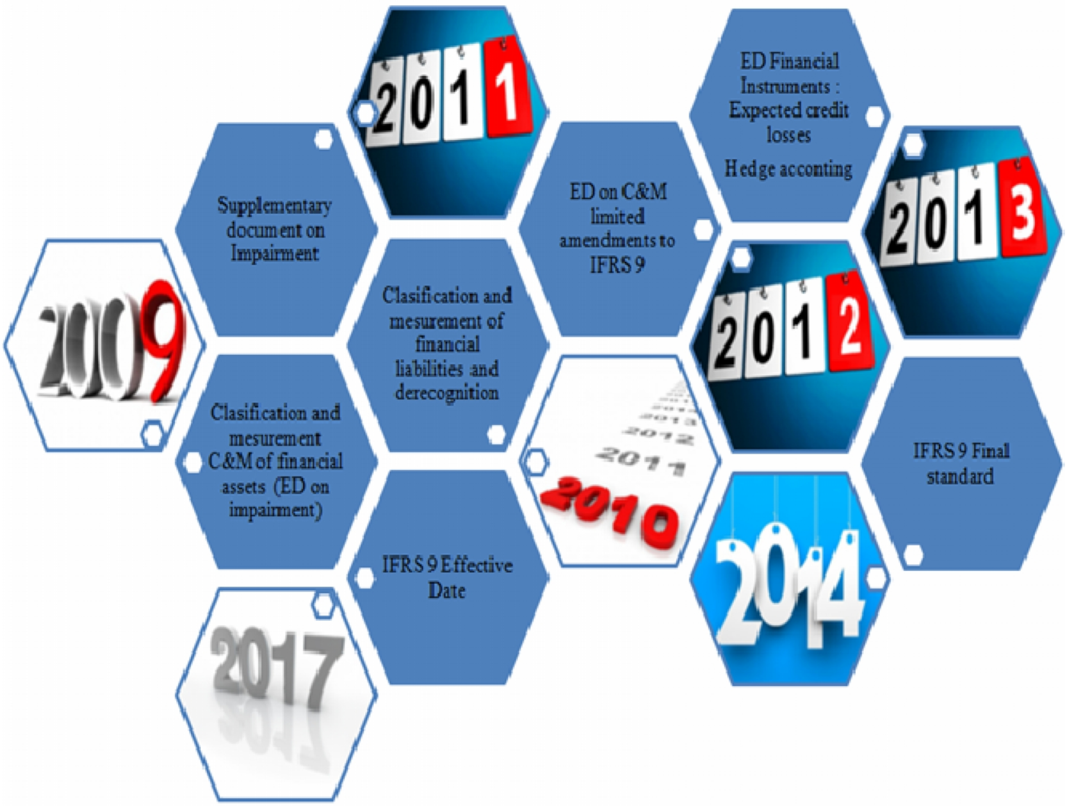
Figure 1. IFRS 9 Implementation within banking sector



Source: projection made by author

The new IFRS 9 standard, released in July 2014, replaced the old IAS 39 Financial Instruments: Recognition and Measurement which had the purpose of recognizing and measuring financial assets, financial liabilities and contracts for buying or selling non-financial assets. IFRS 9 is more forward looking model than its predecessor IAS 39.

The standard is focused on three main areas, the first of which is classification and measurements. By classification and measurement the banks must determine which assets they measure at fair value and which assets they measure at market value, and the way they are categorized and presented in the profit and loss account.

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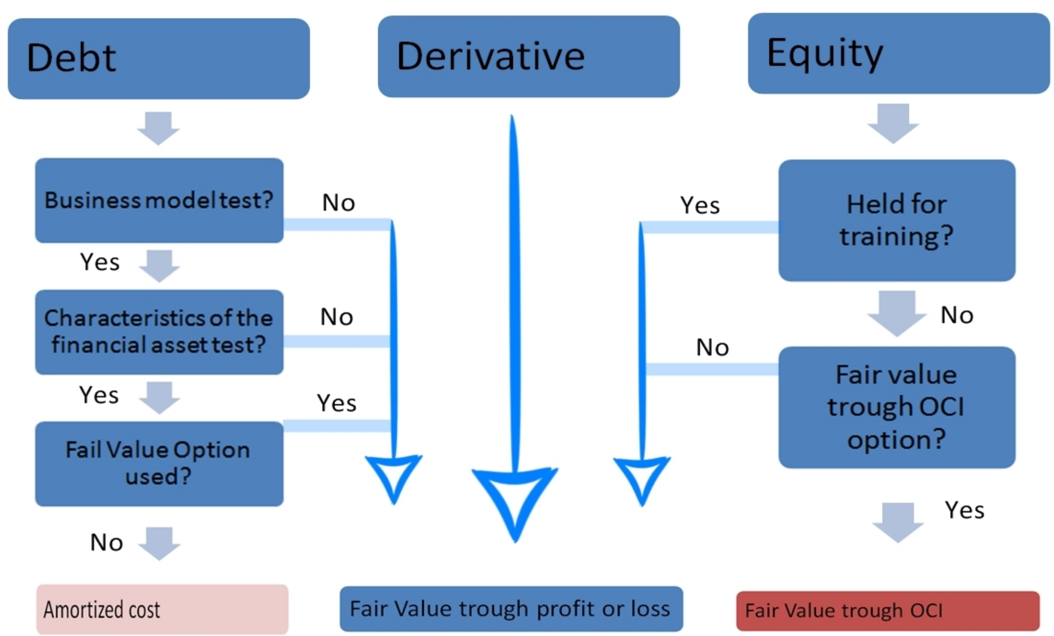
A new step forward for the banking industry under the new international standards is the reduction of classification within the model from four categories of assets, loan and receivables, fair value, held to maturity and available for sale to just three incorporated in the new IFRS 9 standard determined in line with the business model banks implies

In Romanian banking industry the expected loss approach will result in the banks provisions increasing up to 50 percent across all loans asset classes. The new accounting change and the new 2014 international standard changes will cause changes in the banking pricing system and more specifically the cost of capital and the cost of pricing a loan.

Figure 2. Classification and measurement of financial assets



Source: www.ey.com

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A big step forward in our opinion for the banking industry in Romania is the movement form incurred to expect loses because in the past the loan loss provision was not sufficient. In most of European banking sector expected losses have been used for regulatory capital calculation so the move to expected loss in accounting welcomed .

It remains to be seeing if IFRS 9 expected loss provision will be higher than the current regulatory expected loss provisioned and if capital planning uncertainty will continue.

III. Securitization of Banking Assets

Assets represent resources controlled by the entity as a result of past events and from which future economic benefits are expected (Domil, 2014).

Predicting current assets in the small and medium-sized entities is treated with importance but it is not a priority, they are entities with relatively low and constant activity without large fluctuations, which gives the opportunity to maintain a constant level of this category of assets (Cojocaru, Mateș, & Domil, 2014).

Banking assets represents property and other assets of a bank, designed to serve a long time bank activities (Moraru, Moraru, Pavel, Domil, Dumitrescu, & Știrbu, 2006).

Disconnecting the involved functions in securitization significantly alter the traditional role of intermediary banks, there are some reasons of attractiveness for the banks of securing assets. In the case of a bank, assets consist of all its placements in loans in securities, bonds, interbank market, capital market, stock market etc., plus buildings, land, equipment and other assets (participations / shares owned in other companies).

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Figure 3. Assets securitization model

Source: projection made by author

Security can improve credit risk management, because if a bank finds that its loans are pre concentrated in an area, it can secure some of them to reduce exposure. Securing can influence the bank cost of funds, this depending on whether any benefits of securing an asset class is adjusted by increasing funding costs higher due to lower quality loans that remain in balance.

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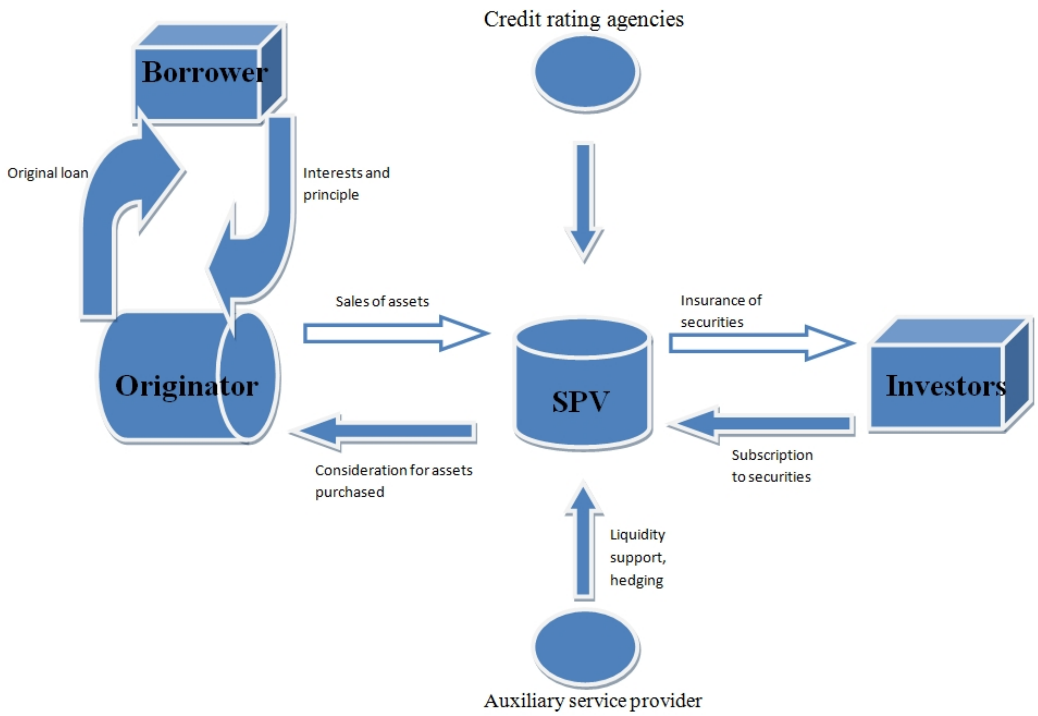
Figure 4. Banking Asset securitization structure



Source: projection made by author

The securitization of banking assets represents a financial innovation witch has a long history in the capital markets. This process implicates the insurance of securities witch derive cash flow from the underlying assets.

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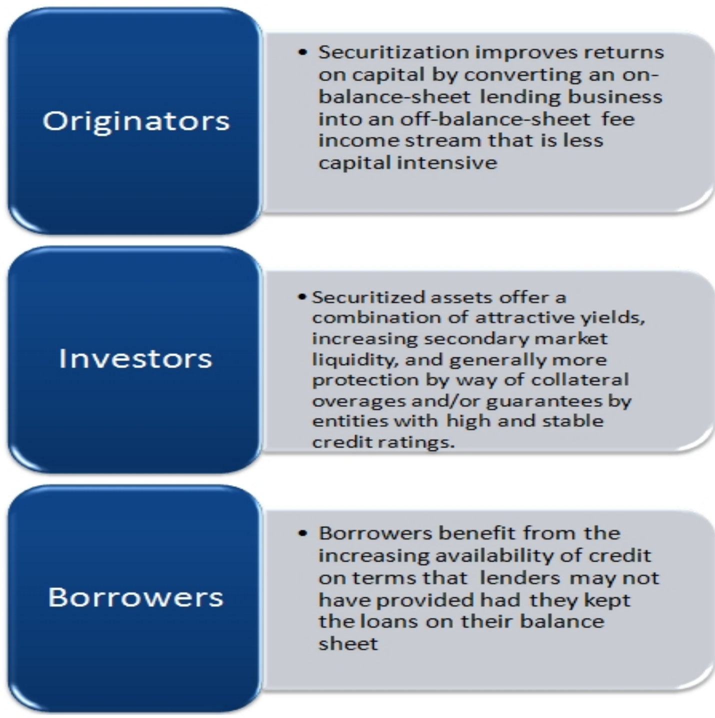
Figure 5. Benefits of asset securitization



IV. BASEL 3 IMPACT ON ASSET SECURITIZATION

The global voluntary regulatory standard, Basel 3 continues on from Basel 2 witches was mainly focused on the level of capital. When lending money, banks engage in activities wearing some level of risks. For this Basel 2 supposes that some risks come with lending and part of the capital must be set aside to cover this risks. The risk is not equal to all of the bank loans and for this reason risks are weighted in order to arrive at the total amount of risk weighted assets.

Basel 2 recommends banks to set aside 2.5 per cent of the risk weighted assets. Basel 3 builds up from Basel 2 and imposes not 2.5 per cent but instead 7 per cent or even more, depending on the nature of the activity and the type of bank witch lead to a considerable increase of the required capital for banks.

The second element Basel 3 adds relates to the size of the balance sheet because in the past years we have seen balance sheets of banks increasing significantly. Basel 3 insists and recommends banks to take initiative to limit this process and even to take initiative to reduce the balance sheet size (Bostan I., Grosu V., Socoliuc M. & Ana Maria Hlaciuc, 2008). This process can be done according to Basel by putting a limit on the size of the activity a bank can develop in comparison to its own capital and for this to occur a leverage ratio has been developed.

The third element added by Basel 3 and probably the most important one is liquidity.

In the context in which banking assets in Eastern Europe are still overrated liquidity is a most important aspect for a financial institution or in our case a bank. A bank receives deposits and grants loans and every day a bank disposes of a certain level of cash through its activity of collecting deposits and by providing cash to clients while granting loans. Due to the recession process we are still facing, it's likely that the bank will not be in equilibrium at the end of the day. If it has more deposits than loans it will deposit some of them in another bank and if it granted more loans that it received deposits it will go or a loan with another bank by the inter banking market.

Asset securitization can improve risk management by controlling the ins and outgoing cash flow of the bank. This cash flow is typical to each bank (for example savings banks are specialized in the collecting of deposits meanwhile a merchant bank is specialized in lending activities).

The success in the banking industry is the equilibrium between its loans and deposits and the securitization of assets is an important insurance of this equilibrium. To ensure such a equilibrium exists, Basel 3 has developed a specific regulation which consists of standardized stress test on all banks. The banks must have sufficient liquidity for a period of 30 days of stress conditions.

The improvement of risk management trough securitizing assets improves also the management of the level of liquidity of the bank but this will put pressure on the net results of a bank and must be done kipping in mind the inquired increase in the capital for banks.

V. Conclusion

Asset securitization represents an important aspect to a commercial bank because of the profitability challenge trough balancing loans and deposits. To manage this equilibrium cross selling is an important aspect to a bank which will lead eventually to operational intimacy which will help banks to retain the required liquidity for the stress test.

The importance of securitization of assets in the banking sector is outlined also by the further deterioration in asset quality in Eastern Europe without of a consolidation of capital required by Basel 3 standard. In the last years the quality of assets is on a negative trend in Central and Eastern Europe. Slowing down economic growth, worsening asset quality and potential funding problems may affect the stability of the financial sector.

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