

The Role of Loan Loss Provisions Under IFRS 9 In Mitigating Aggressive Lending Behavior: By Application in the Union Bank of Iraq

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Abstract

The global financial crisis of 2008 demonstrated the inadequacy of the accounting treatments outlined in International Financial Reporting Standard (IAS) 39, Financial Instruments. This standard relies on an actual loss model for credit loss recognition, meaning losses are only recognized when they occur.

This research aims to discuss the provisions of International Financial Reporting Standard 9 (IFRS 9), particularly regarding Expected Credit Loss (ECL), and its role in mitigating aggressive lending behavior. To achieve the research objectives, several indicators were used on the sample bank, the Iraqi Union Bank, listed on the Iraq Stock Exchange. These indicators included the LGR, the Loans-to-Deposits Ratio (LDR), the Change in Loss Items (ΔLLP), the Return on Equity (ROA), and the liquidity calculation using the ratio of operating cash flow to total assets. A simple regression model was then applied to arrive at the research findings. The research reached several conclusions, the most important of which was that applying International Financial Reporting Standard (IFRS 9) contributes to reducing aggressive lending behavior by banks towards customers.

Keywords: *IFRS 9; loan-loss provisioning; expected credit loss; aggressive lending behavior.*

1. Introduction

The stability of the banking system and effective risk management, particularly regarding risks arising from lending to customers, can contribute to improving banks' financial performance. Therefore, it is essential for banks to be able to mitigate such risks. Conversely, the risk of customer loan defaults exposes banks to a decrease in asset value and a reduced ability to meet their obligations and deposits. Thus, it is crucial for banks to be able to manage such risks. The research problem lies in a fundamental question: What is the role of loan loss provisions, according to IFRS 9, in mitigating aggressive lending behavior?

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This research aims to discuss the provisions of IFRS 9, specifically concerning expected credit losses (ECL), and how they contribute to reducing aggressive lending behavior.

This research is based on the main hypothesis that International Financial Reporting Standard 9 (IFRS 9), particularly provisions for loan losses, plays a role in mitigating aggressive lending behavior. The importance of this research stems from the need to stabilize the banking system and address the issue of loan defaults by customers.

To achieve the research objective, the following indicators of aggressive lending were used: the Loan Growth Rate (LGR) and the Loans-to-Deposits Ratio (LDR). The Change in Losses per Item (ΔLLP) was also employed, along with the Return on Equity (ROA) ratio and the calculation of liquidity through operating cash flow as a percentage of total assets. Simple regression analysis was then applied to arrive at the research findings.

2. International Financial Reporting Standard (IFRS9)

In light of the criticisms directed at International Financial Reporting Standard (IAS39) Financial Instruments, the Accounting Standards Board issued the International Financial Reporting Standard (IFRS9), through which it compelled accounting standard-setters and persons responsible for accounting principles, including banks, to recognize and disclose credit losses in the financial statements through (Expected Credit Loss - ECL). This standard was applied on January 1, 2018. Through this approach, the entity recognizes losses on a projected rather than an actual basis. This project has received considerable support as it includes several changes related to the measurement and classification of financial instruments (Wafaa Yousef Ahmed: 2016).

The shift from International Financial Reporting Standard (IAS 39) to International Financial Reporting Standard (IFRS 9) represents a significant change in the accounting for financial instruments, moving from a rules-based to a principles-based standard. IFRS 9 requires the recognition of expected credit losses at the reporting date to reflect changes in the credit risk of financial instruments. This helps update all data for calculating expected credit losses, meaning that a loss event is no longer required for credit losses to be recognized (Mojca Gornjak, 2017).

3. Requirements of International Financial Reporting Standard (IFRS 9)

Under this standard, an economic entity must classify and measure financial assets and financial liabilities. Furthermore, the standard requires the recognition of expected credit losses not in all cases, but only when there is clear evidence confirming the existence of a loss. It also compels economic entities to update the amount of recognized expected credit losses with each financial reporting, leading to greater transparency and timely recognition, and reflecting changes in the asset's credit risk. Implementing the standard requires three steps, as follows: (IFRS: 2014):

- a. **Classification and Measurement of Financial Assets and Liabilities:** An economic entity must recognize a financial asset or liability only when the entity becomes a party to the contractual terms of the asset.
- b. **Impairment of Financial Instruments:** The standard emphasizes that economic entities must recognize credit losses differently than those used in International Accounting Standard 39. Furthermore, it adopts the approach of expected future losses (i.e., it recognizes losses before they occur) and measures losses based on information relating to past events (Canals: 2020).
- c. **Hedge Accounting:** The standard includes significant amendments, expanding the scope of hedge accounting to include more disclosure of risk management activities (Al-Amir :2019).

4. Aggressive Lending Behavior

Lending is a major source of external financing for the real sector worldwide, contributing to real sector growth through the formation of working capital by firms and the promotion of consumption of goods and services by society

(ashraf : 2019). It has been defined as a process whereby services are allowed to be acquired without immediate payment based on a contractual agreement to pay later. (Simpson: 2014). Bank loans are a form of direct credit, providing a degree of liquidity to the customer. There are three types of bank loans: short-term, medium-term, and long-term. The importance of risk management is only clearly evident in medium- and long-term loans, as risks increase with the loan term (Hussein & Arhaim :2017).

5. Expected Credit Loss (ECL) model

The Expected Credit Loss (ECL) model aims to recognize losses in a timely manner by eliminating the trigger event requirement of IFRS 39, which previously allowed banks to only create provisions for loan losses upon the occurrence of specific events, such as a default on principal repayment (IAS 39.59(b)).

A key feature of the ECL model is the ability to recognize losses in a timely manner while increasing the margin of discretion:

(1) **Stage classification**, i.e., expanding the scope of impairment rules to include unaffected exposures, and

(2) **Measurement of expected credit losses (ECL)**. First, unlike IAS 39, banks must always create provisions for expected credit losses (ECL) for all assets within the three-stage model, starting from initial recognition.

Stage one includes financial assets whose credit risk has not increased significantly since initial recognition (IFRS 9.5.5.5), as well as all newly issued financial assets.

Stage two includes financial assets whose credit risk has increased significantly since initial recognition, for example, if the borrower experiences an actual or anticipated decline in revenue, negatively impacting its ability to meet its obligations (IFRS 9.B5.5.17(f)).

Stage three includes financial assets experiencing credit impairment, i.e., an adverse event affecting future cash flows (IFRS 9.A). This latter definition is consistent with the definition of non-performing assets under IFRS 39. (Mohamed Lotfy Hassouna, 2017.)

6. Challenges Facing the Implementation of the Expected Credit Loss Model

Undoubtedly, banks will face numerous challenges and obstacles when implementing the Expected Credit Loss model according to International Financial Reporting Standard (IFRS) 9 (Financial Instruments - Recognition and Measurement). Here, the researcher will review some of the challenges and obstacles that will hinder the implementation of the new model according to (IFRS9). These challenges can be summarized as follows:

- a. For the Expected Credit Loss model to be implemented correctly, it requires the **integration of financial data and risk**. It also requires a **database to collect and store** a large amount of accurate and reliable information, not only historical data but also information about future events and economic conditions. All recorded information must be verified and its compliance with generally accepted accounting principles ensured. Furthermore, it requires enhanced coordination between specialized departments such as Risk Management, Credit Management, Finance, Compliance, and Information Technology to develop more accurate expected loss models (Nabil Abdel Raouf Ibrahim, 2018).
- b. **Reclassifying some financial instruments** classified under IAS 39, titled "Financial Instruments," under IFRS 9, titled "Financial Instruments – Recognition and Measurement Based on the Entity's Business Model" (Mohammed Al-Mahdi Al-Amir, 2017).
- c. Although the International Accounting Standards Board (IASB) emphasized the implementation of the expected credit loss model without unnecessary **additional costs**, its application is expected to

result in expenditures exceeding one million US dollars due to modifications to various accounting systems to comply with the new requirements of IFRS 9 (Giorgio Baldassarri : 2017).

7. Methodology

Research Design: In this research, quantitative analysis was used based on data from the Iraqi Union Bank published in the Iraq Stock Exchange to determine the extent to which the application of (IFRS 9) contributes to reducing aggressive lending behavior.

Sample : The stock market was used as the population, and the published data of the Iraqi Union Bank, listed on the Iraq Stock Exchange (Annual financial statements) , was used as the research sample.

i. Balance sheet for the Iraqi Union Bank for Period(2021–2024)

Items	2021	2022	2023	2024
Cash	48,650,345	49,364,988	72,453,317	54,699,502
Other Bank Balances	622,719	650,644	(653,177)	635,547
Credit Facilities	354,538,616	353,002,902	332,663,823	304,390,562
Financial Assets fair value	843,696	867,209	896,896	930,042
Property and Equipment	23,960,556	21,769,242	21,563,148	43,625,007
Other Assets	63,216,293	97,176,292	94,066,092	132,309,347
Total Assets	491,832,225	522,831,277	520,990,099	536,590,007
Liabilities and Shareholders' Equity				
Liabilities				
Loans Received	51,509,856	65,603,007	58,404,066	56,667,167
Customer Deposits	83,728,868	86,778,493	92,861,245	67,902,291
Cash Margins	80,873,062	87,302,323	85,030,837	85,751,444
Miscellaneous Provisions	4,090,792	4,090,792	4,114,793	5,349,903
Income Tax Provisions	1,058,908	564,044	1,447,720	1,878,188
Other Liabilities	6,009,170	564,044	8,000,998	22,560,207
Total Liabilities and Shareholders' Equity	227,270,655	255,803,185	249,859,658	240,109,200
Share Capital	252,000,000	252,000,000	252,000,000	252,000,000
General Reserves	8,292	8,292	8,292	8,292
Statutory Reserve	4,890,266	5,010,066	5,211,656	5,333,622
Expansion Reserve	4,900,000	4,900,000	4,900,000	4,900,000
Retained Earnings	2,809,950	5,104,393	8,975,465	11,377,044
Accumulated Deficit	(28,766)	000	000	22,793,674
Fair Value Reserve	(18,172)	5,341	35,028	68,175
Total Shareholders' Equity	264,561,570	267,028,092	271,130,441	296,480,807
Total Liabilities and Shareholders' Equity	491,832,225	581,517,415	520,990,099	536,590,007

ii. **Income statements for the Iraqi Union Bank for Period(2021–2024)**

Items	2021	2022	2023	2024
Interest Income	3,699,856	2,311,552	4,381,931	4,379,952
Interest Expense	(1,987,650)	(4,970,650)	(2,017,429)	(3,057,308)
Net Foreign Exchange Income	1,712,206	2,659,098	2,364,502	1,322,644
Net Commission Income	(436,122)	(90,191)	10,498,237	26,392,442
Total Foreign Exchange and Commission Income	8,203,151	13,368,546	8,739,115	25,868,885
Foreign Exchange Income	7,767,029	13,278,355	377,363	33,619
Other Operating Income	564,898	282,201	816,176	385,534
Net Operating Income	299,437	301,617	12,297,156	28,133,832
Salaries and Wages	10,343,570	11,203,075	3,310,508	3,302,522
Depreciation and Amortization	415,147	424,503	339,730	339,671
Other Operating Expenses	5,179,595	4,546,324	3,807,450	3,989,928
Total Operating Expenses	(9,106,998)	(8,338,851)	(7,481,688)	(25,264,050)
Net Profit Before Tax	1,236,572	2,864,224	4,815,468	2,869,782
Income Tax	(226,256)	(468,215)	(783,676)	(430,468)
Net Profit After Tax	1,010,316	2,396,009	4,031,792	2,439,314

In this part we will Identify Variables which used in this research

1. Loan Growth Rate (LGR)
2. Loan-to-Deposit Ratio (LDR)
3. Bank Size (In Total Assets)
4. ROA = Net Income / Total Assets
5. Liquidity = Operating Cash Flow / Total Assets

a. **Loan Growth Rate (Aggressive Lending)**

$$\text{LGR} = \frac{\text{Loans } t - \text{Loans } t-1}{\text{Loans } t-1}$$

Table (1) Loan Growth Rate (LGR)

Year	Loans	Loan Growth	Ratio
2021	354,538,616		
2022	353,002,902	$(353,002,902 - 354,538,616) \div 354,538,616 =$	-0.43%
2023	332,663,823	$(332,663,823 - 353,002,902) \div 353,002,902 =$	-5.76%
2024	304,390,562	$(304,390,562 - 332,663,823) \div 332,663,823 =$	-8.48%

Source: Prepared by the researcher.

The table above shows that loan growth is experiencing a sharp decline, which means a decrease in aggressive lending behavior over the years under review.

b. **Loan-to-Deposit Ratio (Aggressive Lending)**

$$\text{LGR} = \frac{\text{Loans}}{\text{deposits}}$$

Table (2) Loan-to-Deposit Ratio (LDR)

Year	Loans	deposits	Ratio
2021	354,538,616	83,728,868	4.23
2022	353,002,902	86,778,493	4.06
2023	332,663,823	92,861,245	3.58
2024	304,390,562	67,902,291	4.48

Source: Prepared by the researcher.

A loan-to-deposit ratio > 1 = high-risk lending.

The table above shows that the loan-to-deposit ratio is very high (the bank lends between 300% and 400% of its deposits), which represents high-risk lending.

c. ROA (Profitability Control Variable)

$$ROA = \frac{\text{net profit}}{\text{total assets}}$$

Table (3) ROA (Profitability Control Variable)

Year	Net profit	Total Assets	ROA
2021	1,010,316	491,832,225	0.21%
2022	2,396,009	522,831,277	0.46%
2023	4,031,792	520,990,099	0.77%
2024	2,439,314	536,590,007	0.45%

Source: Prepared by the researcher.

d. Bank Size (ln Total Assets)

This is calculated easily during regression.

$$\ln(2021) = (491,832,225) \approx 20.01$$

$$\ln(2022) = (522,831,277) \approx 20.08$$

$$\ln(2023) = (520,990,099) \approx 20.06$$

$$\ln(2024) = (536,590,007) \approx 20.10$$

e. Liquidity (OCF ÷ Total Assets)

$$\text{Liquidity} = \frac{\text{operating cash flow}}{\text{total assets}}$$

Table (4) Liquidity

Year	OCF	Total Assets	liquidity
2021	24,836,277	491,832,225	5.05%
2022	14,201,315	522,831,277	2.71%
2023	28,976,215	520,990,099	5.56%
2024	15,719,538	536,590,007	2.93%

Source: Prepared by the researcher.

Below is a summary of what is being presented in the tables.

Table (5)

Year	LGR	LDR	ROA	Liquidity	Size (ln TA)
2021	-	4.23	0.21%	5.05%	20.01
2022	0.43%	4.06	0.46%	2.71%	20.08
2023	5.76%	3.58	0.77%	5.56%	20.07
2024	8.48%	4.48	0.45%	2.93%	20.10

Source: Prepared by the researcher.

8. Conclusion

The above demonstrates a sharp decline in aggressive lending behavior, particularly during the years used (2021-2024). However, the loan-to-deposit ratio remains very high, indicating high-risk lending. The profitability of the entity's assets fluctuates from year to year. Finally, it can be said that a clear improvement has been achieved through the application of (IFRS 9) compared to previous years when (IAS 39) was applied.

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