

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

Ahmed Taher Kadhim Al-Anbagi

Middle Technical University
Technical College of Management– Baghdad
ORCID: 0000-0002-7692-1063

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Abstract

This research aims to discuss the difference between IFRS (9) and its requirements throw loan loss provision and IAS (39) with shortcomings in treatment for accounting transaction in banks specially.

The international financial accounting standard (IFRS9) focused on expected credit loss (ECL) and the research used and test (ECL) in mitigating aggressive lending behavior by Iraqi banks (union bank of Iraq).

To achieve these goals we used many indicators which is represented by (lone-to-deposit ratio, changes in loss items, return on equity and liquidity ratios).

This research reached finally that the apply IFRS 9 in Iraqi bank contributes in reducing aggressive lending behavior.

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

1. Introduction

The Iraqi banks systems suffer from many problems, in particular which are related with instability and problem which are related with aggressive lending behavior to the customers.

This problems leads to payments defaulting by customer on their debits and unable to meet their obligation to the banks.

And this problems leads to reduce the value of banks assets and not able to meet obligation and protect its deposits.

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This study aims to discuss the international financial standards reporting (9) specifically (ECL) expected credit loss and its roles in reducing aggressive lending behavior by banks to customers.

The hypothesis of this study represents: (the IFRS 9 and its requirements have a role in reducing aggressive lending behavior by Iraqi banks to customers).

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. (Wafaa Yousef Ahmed: 2016).

The process of updating accounting standards, governed by environmental changes, from International Accounting Standards (AIS 39) to International Financial Reporting Standards (IFRS9) is a fundamental shift in accounting. (Mojca Gornjak, 2017).

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

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 follows:

- a. For apply (ECL) expected credit loss models required big database to collect and store information, and this information should be accurate and reliable. And challenges represent enhanced coordination between many of department such as (RM) risk management, credit management (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.(**As in the appendix at the end of the research**)

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

- a. Loan Growth Rate (LGR)
- b. Loan-to-Deposit Ratio (LDR)
- c. Bank Size (In Total Assets)
- d. ROA = Net Income / Total Assets

e. 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)**

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

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)

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

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 (In 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 (In 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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Appendix :

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