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The Impact of Applying the Expected Credit Loss (ECL) Model According to IFRS 9 on Capital Adequacy in the Iraqi Banking Sector

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Abstract: This paper seeks to evaluate the effect of utilizing the International Financial Reporting Standard (IFRS9); in particular, Expected Credit Loss (ECL) model on the capital adequacy of Iraqi commercial banks. A descriptive and analytical method was adopted with the use of panel data for a group of 10 private sector banks listed on Iraq Stock Exchange for the duration (2014-2023). This period was further broken down into pre- (2014-17) and post-application (2018-23). The findings indicated a positive and significant effect of adoption of IFRS 9 on capital adequacy. The enhanced medium banks' ability to, independently and ahead of time, anticipate future credit losses allowed them to bolster the strength of their capital stockpile and their resilience to financial shocks. The research suggests supporting Iraqi banks to fully implement the conditions of applying IFRS9, in addition to Building risk management systems and committing to Basel III Conditions. This would enhance the financial stability of the banking sector in Iraq.

Keywords: International Financial Reporting Standard (IFRS9) – Expected Credit Loss (ECL) – Capital Adequacy.

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1. Introduction

The rapid pace of technological change, improved access to financial markets and the emergence from various successive financial crises has resulted in significant changes in global banking industry [1]. The financial meltdown of 2008 made the case for a more pragmatic, flexible set of accounting standards that take into account financial risk. In this context, a significant standard (IFRS 9) issued relating to the accounting of financial instruments replaced the incurred loss model in IAS 39 by the Expected Credit Loss (ECL) model.

It's regarded as one of the most significant accounting changes as banks are required to recognize potential losses earlier and prepare for them before they eventuate. This improves the resilience of the banking sector to shocks, and also affects important financial ratios such as capital adequacy which is an essential criterion for evaluating banks' creditworthiness [2], [3]. While the significance of this standard on international level, there is limited research that examining effects of applying this standard on Iraqi banking sector due to being a specific economic environment. This renders the field promising in terms of both academic interest and practical value [4].

Research Problem

IFRS9 adoption which is designed to bring more transparency and stability in the financial system, through adopting Expected Credit Loss model implementation may make significant impact on the banks' capital adequacy, especially in the weak or ongoing economy challenged countries as Iraq. Consequently, the main research question is: What are the effects for capital adequacy and credit rating of Iraqi commercial banks when adopting IFRS9 model according to ECL?

Research Significance

Several factors make this study significant:

Scientific Value: The contribution of this study lies in its addition to the available literature on IFRS 9 and by investigating its application in a developing banking economy such as Iraq, in which studies considering this matter are scarce.

Practical Implications: The research is significant in that it offers findings from which Iraqi banks managers to take into account the real impact of implementation of ECL model on Capital Adequacy and Credit ratings.

Policy Relevance: It offers policymakers and regulators (e.g. the Central Bank of Iraq) benchmarks about how much they can focus on the inflict on financial stability effect from the new standard. This is in favour of better regulatory decisions.

Relevance of Investment: It offers investors and credit rating agencies new instruments to assess the financial soundness of Iraqi banks.

Research Objectives

The research aims to:

Discuss the effect of IFRS 9 adoption on Iraqi commercial banks 'capital adequacy ratios.

Analyze the direct and indirect consequences of adoption of the ECL model on banks' performance.

Explain the relationship between capital adequacy ratios and the credit rating of Iraqi banks in relation to this standard.

Evaluate the level of preparedness on the part of Iraqi banks for the implementation of IFRS 9 including from a regulatory and practical point of view.

Suggest concrete steps to strengthen the contribution of the standard on financial stability and investor confidence.

Research Hypothesis:

We aim to test the following hypothesis in our present work:

5- Main Hypothesis There is a positive effect for applying IFRS9 on capital adequacy in the Iraqi commercial banks.

2.0 THEORETICAL AND CONCEPTUAL FRAMEWORK OF THE STUDY

1: Birth, Concept and Evolution of IFRS9

The notion of financial reporting arises from: the main purpose of financial statements - to offer users appropriate accounting information with which they can make economic, administrative and social decisions. In the late years of the decade and with a vengeance following the Global Financial Crisis (GFC) of 2008, accounting rose to become central in debates about 'capitalism's excesses' – including fraudulent use of financial standards in America, where they were being used as part of a frenzy around reporting earnings and assets. This underscored the importance on creating those standards to promote quality and transparency in reporting of financial information.

2. Materials and Methods

One such major weakness was IAS 39, which was specifically in relation to financial instruments accounting, and largely exacerbated the crisis. The International Accounting Standards Board (IASB) and the US GAAP Financial Accounting Standards Board (FASB) responded by developing standards intended to increase transparency and enhance the quality of financial information.

IFRS 9 was a response to the financial crisis inspired by the 'Norwalk Agreement'. But the shock of the financial crisis forced it to grow up fast in response to IAS 39's

inadequacies. On the 24 July 2014, it issued IFRS 9 "Financial Instruments" replacing the standard IAS 39 [27]. On the same day, the Board also published a press release on its website announcing completion of the project to replace IAS 39.

The most important feature of IFRS 9 is the adopted credit impairment model expected in place of incurred loss model, with greater emphasis on financial reporting and more objective recognition provisions to hedge against potential risk. The academic says that the standard is a vital part of improving the quality of financial information and preventing future shocks in crises.

Second: Recognition of Expected Credit Losses (ECL) under IFRS9 guidelines:

ECLs refer to an estimate of credit losses that the entity will incur over the life of a financial instrument, which is calculated as its present value. Such deficiencies result from the spread between cash flows payable to or receivable by the entity under the contract and those expected by it. Given that the ECL model also includes a measure of time, and not just amount, a credit loss might arise when an entity expects to receive full compensation later in time compared to the contractual date.

ECL are a component of the measurement of financial assets at an amortised cost. IFRS 9 obliges financial institutions to recognise such losses for financial assets at amortised cost, as well as those measured at fair value through other comprehensive income. It does not specify one single approach, but provides three different methods for calculating and recognising expected credit losses.

The General Approach: This approach is the primary method set out in the standard. Estimating expected credit losses (ECL) involves classifying the financial instrument into one of three stages reflecting changes in its credit quality since initial recognition.

A. Stage 1: A. (1) This level comprises the financial assets for which there has not been a significant increase in credit risk (SICR) since initial recognition.

Stage 2: Applied to financial assets where there has been a significant increase in credit risk reported since initial recognition, which are not yet Past Due.

Stage 3: Financial instruments that are credit-impaired are classified in this category.

B. Simplified Approach: : An entity may apply a practical expedient to the measurement of the allowance for expected credit losses on trade receivables, contract assets and lease receivables. An entity is required to always calculate the loss allowance on a lifetime expected credit losses amount.

The entities may apply the model described in IFRS 9 to trade receivables or contract assets that are subject to the requirements of IFRS 15, and meet either the criteria as having no significant financing component (e.g. goods sold on deferred payment for more than one year) or containing a significant financing component under this standard, provided that they have elected such accounting policy. The lifetime expected loss is measured by using the formula to estimate the allowance. The value of this allowance is estimated with the lifetime expected credit loss calculation.

A lessor may apply a loss allowance for lease receivables arising from transactions within the scope of IFRS 16 if it elects to account for them using this accounting policy. This allowance is determined based on the lifetime expected credit loss model applied to receivables. It applies to all lease receivables and can also be applied separately for finance and operating lease receivables. The accounting policy for trade receivables, lease receivables and contract assets can be selected freely by entities separately.

C. Purchased or Originated Credit-Impaired (POCI) Approach The accounting for credit-impaired financial assets is consistent with IAS 39 when purchased or originated. Interest revenue on the assets is determined by applying the credit-adjusted effective interest rate to the amortised cost since initial recognition and a loss allowance for changes in lifetime expected credit losses. A 12-month expected

credit loss allowance is not recorded on financial assets that were credit impaired when first recognised. This is because such losses would have already been taken into account in the fair values recognised when this approach was first adopted. This option is less commonly used than others, and IFRS9 mainly addresses impairment of financial instruments under the general approach. Lending to credit-impaired borrowers You should consider the following factors when you purchase or originate a loan that is credit-impaired.

Material financial distress of the issuer or borrower.

Violation of any terms contained a contract Default or late payment.

The lender that makes a concession to the borrower for economic or legal reasons resulting from financial difficulties of the borrower.

The probability of the borrower defaulting, becoming insolvent or seeking financial reorganisation.

The absence of a market for the loan in question because of financial troubles

The loan was originated or purchased at a discount which provided for credit losses.

3. Results and Discussion

Concept and Significance of Capital Adequacy: The process for the disintegration of the Bretton Woods system in 1971 brought about instability in world financial markets, leading to successive banking crises eroding confidence in them.

In reaction to this, the term "capital adequacy" became one of the most important measures for analyzing health and stability of a banking system [5]. Capital adequacy refers to the ability of a bank to absorb unexpected losses stemming from all types of risk it is exposed to: credit, market (ie interest rate and price), operational, as well as risks arising from off-balance sheet activities.

It's the single most critical measure of bank soundness. It's goal is to keep the minimal capital through which, leveraging, risk cover and nice deposits are obtained and investment in rest for growth.

First: Definition of Capital Adequacy: Capital adequacy is first layer of defense for banks that can absorb losses without diluting the depositors' claims on assets is also seen to be enhancing creditors' confidence in fulfillment of contractual obligations.

Calculated by determining the proportion of a bank's capital to its risk-weighted assets, it is an important factor reflecting financial soundness and has thus become one measure that contributes significantly to depositor confidence and system stability [6], [7].

Generally, maintaining adequate capital is a basis for bank stability as the bank may absorb risks and losses using its own resources. It guarantees the sustainability of its developing and prevents it from getting to bankruptcy and over leveraging.

Secondly: The Importance of Proper Levels of Capital Banks capital is one of the key elements in financial system soundness, find a strong correlation between a bank's ability to support losses and the security for depositor or creditor wealth [8], [9]. Capital adequacy has gained much more attention after crises, for example since the global debt crisis when it turned out that lending expansions without capital are a recipe for failure of banks. This has led the regulators to raise their standards in order to avoid bankruptcy of the banking system [10], [11].

The significance of capital adequacy and its summary are also given as follows:

A safety valve that shields banks from crises and balances risk against capital.

A source of confidence for existing and prospective depositors.

Its real differentiation however, was as an essential determinant of central bank assessments and subsequent classification of banks such as (CAMELS).

The researcher holds a view which is that capital adequacy is necessary for the survival of a financial system. It is not the only solution but will require all stakeholders to come together to protect the financial sector as well as other reforms at supervision, and economic fundamentals [11].

Third: Determinants of Capital Adequacy: The factors influencing capital adequacy are many and the most significant among them are :

Size of the Banks: Big banks enjoy economies of scale and also have diversified business, lowering their costs and risk profiles while providing them access to cheap funding.

Bank Liquidity: The bank's liquidity is how it can fulfill its responsibilities. Liquidity, however, is a two-edged sword: If it's too high, the safety of the bank goes up but profitability hits the skids; if too low, the solvency of the bank could be in jeopardy.

Credit Risk: The risk that borrowers won't repay their loans. The more these risks increase, the higher the amount of capital a bank has to raise as a buffer against potential losses and that reduces its capital adequacy ratio.

Results from the Field Study: Presentation and Analysis

The Study Population and Sample The study population is in the Iraq banking sector which considered as one of the most important pillars that played significant role to support national economy through providing finance to different economic sectors [12]. It includes government & commercial banks as well as Islamic banks, under the control of the Central Bank of Iraq. It is actively involved in mobilising savings, granting credits and implementing monetary policies. Iraq has 64 commercial banks, which are supportive of the national economy [13], [14].

The structural analysis model will employ a balanced panel data of a sample size of ten Iraqi listed banks on the Iraqi Stock Exchange, and we have measured cumulatively one hundred yearly observations. These are gathered from the annual financial statements of these banks made available on the Iraq stock exchange website [15], [16]. Therefore, the sample of the study is 15.6\% of total population to be studied.

Discussion

The purposively selected study sample "Table 1" was based on certain criteria that fit with the objectives of the study. The banks are two of the most involved firms in the Iraqi banking sector.

Table 1. Sample study

Private Commercial Banks	
1. Baghdad Bank	6. Trans Iraq Bank
2. Middle East Iraqi Investment Bank	7. Regional Commercial Bank for Investment and Finance
3. Iraqi Investment Bank	8. Ashur International Bank
4. National Bank of Iraq	9. Gulf Commercial Bank
5. Iraqi Credit Bank	10. Al-Mansour Bank

Descriptive Analysis: Table 2 presents the results of the descriptive statistics.

Table 2. Descriptive statistics for variables, 2014 – 2023 (n = 10)

	Unit	Obs.	Mean	Median	Std. Dev.	Min	Max	Normality
Dependent Variables:								
Capital adequacy	(%)	100	1.3937	1.0600	0.914	0.15	3.99	[26.140]***
Independent Variables:								
IFRS	(dummy 0 - 1)	100	0.5	0.5	0.503	0	1	[16.667]***
Control Variables:								
Bank Size	Logarithm	100	20.368	20.259	0.488	19.607	22.105	[20.604]***

<i>Financial Leverage</i>	(%)	100	2.5787	2.1494	1.416	1	7.9652	[72.697]***
<i>Sales growth</i>	(growth %)	100	0.1958	0.0051	0.877	-1.0788	5.3562	[1068.9]***

Note: ***, **, * indicate significance at 1%, 5% and 10% respectively.

The descriptive statistics of the major variables analyzed in the study are shown in Table 2, where it shows an average over ten years (2014-2023) for a sample of ten Iraqi banks that have a total of 100 annual observations. The goal of this examination is to obtain a summary of the features in advance for the inferential analysis process.

Capital Adequacy Variable The mean capital adequacy is 1.3937% and the median is 1.0600%. The mean-median gap and the high value of standard deviation (0.914) show that there is a lot of variation in capital adequacy among banks as well as across time in the sample period. There is a wide distribution of capital adequacy ratio, from 0.15% to 3.99%, which justifies such an extreme inequality. The large deviation from normal distribution (normality = 26.140*) indicates that the data does not fit a normal distribution. For this, we need to apply an appropriate method of analysis for such data [17], [18]. Typically, this relatively low average capital adequacy may point to the banks being more vulnerable to risk or having a poor resistance capacity against financial disturbances.

IFRS Adoption Variable: The means and medians of the IFRS adoption variable, (which is equal to 0 or 1 on average), both equal 0.5. Half of the sample thus observed adopted these standards (or were in adoption phase), half did not adopt them within the study period. This allows enough variability to examine the effect of IFRS adoption. This bimodal distribution is captured by the small standard deviation of 0.503. High level of the statistical significance (normality = 16.667*) shows, that this variable is not normally distributed (i.e., the dependent value range is just 2), as should be when we consider a dichotomic dummy [19].

Bank Size: Bank size was measured by logarithm, and the mean value was 20.368 with a median of 20.259. The low standard deviation is 0.488, which means the size of the banks in sample after logarithm transformation are close to each other and can reduce the influence of outliers. Banksizes fall between 19.607 and 22.105. The non-normal distribution (normality = 20.604*) indicates that this should be taken into account when models are applied.

Financial Leverage: The mean financial leverage was 2.5787% (median=2.1494%). That is, the banks in are relatively well-funded through external sources. The standard deviation (1.416) indicates some deviation in the level of financial leverage. Values varied between 1% and 7.9652%, giving broad range to analyze impact of the variable. Like all other variables, financial leverage is not normally distributed (normality = 72.697*).

Sales Growth Average sales growth 0.1958% compared to it's median which was 0.0051. The substantial size and implication of the difference between mean and median with a large standard deviation (0.877) indicate significant pathways without affecting whether or not the banks obtain sales growth as well at different timings. Values between -1.0788% (contraction) and 5.3562% were observed, indicating a dynamic operational environment. The high value of non-normality (normality =1068.9*) indicates outliers or sales-growth right skewness [21], [22].

Descriptive analysis The descriptive statistics indicates that data of the study have considerable variation and there are a clear variation among banks in term of capital adequacy, financial leverage and sales growth. But following logarithm adjustment, bank size remain quite close [23]. The majority of the normality test statistics also suggest that the variables are not normally distributed. This calls for a powerful statistical model that can be applied in the case of panel data and is not strongly based on normality assumptions. Regression models that have adapted for variation are an example of such

models. These data attributes have a strong basis for inferring association between capital adequacy and IFRS [24].

Statistical Inference: Table 3 demonstrates the outcome of inferential statistics and hypothesis testing.

Table 3. IFRS Adoption, Capital adequacy: SEM_1.

Paths	Expected signal	Unstandar dized Coefficient	Standardiz ed Coefficient	Std. Err.	z stats.	p > z
Constant	n/a	2.0835	22.926	1.631	12.8	0.000***
IFRS Adoption → + Capital adequacy		-0.3155	-0.1736	0.038	-8.32	0.000***

Note: *** indicates statistical significance at the 1% level.

Actually, Table 3 reports inferential statistics and hypothesis testing results related to the adoption of International Financial Reporting Standards (IFRS adoption) affects on capital adequacy in Iraqi commercial banks according to structural equation modelling (SEM-1).

Unstandardized and Standardized Coefficients:

Ø The link "IFRS Adoption → Capital adequacy" has a non-standardized weight of -0.3155 and a standardized weight of -0.1736. Both coefficients are negative, meaning a negative association between IFRS adoption and capital adequacy. That is, as the IFRS-adopting bodies increase, capital adequacy decreases and its opposite happens.

Ø The standardized coefficient (-0.1736) indicates that as IFRS adoption increases by one standard deviation, the capital adequacy will decrease by 0.1736 in terms of its standard deviation.

Standard Error (Std. Err.) and z-statistic (z stats.):

Ø The path coefficient's standard error of 0.038 is quite low and precise.

Ø z- in practice: • Negative = we reject the null hypothesis that $\beta=0$ at a high confidence level (1% or 5%) (economists often use these levels) – The true value of β is not 0, meaning there really is a relationship. Ø The z-statistic here is -8.32- which means it's "large" (in absolute terms): Magnitude indicates if this the value of our coefficient really could be zero. P-value ($p > |z|$): The p value of the path "IFRS Adoption → Capital adequacy" is 0.000.

Since negative and significant effect of the IFRS adoption on capital adequacy in findings bobves who one of nature these mind which is rejected the main hypothesis to have positive impact.

4. Conclusion

5-2-Driving factors of Capital Adequacy: The findings suggest that the adoption of IFRS9 has negative effect with a significant association on the capital adequacy level within Iraq commercial banks. This in turn means that taking on the standard has resulted in reduced capital adequacy ratios, going against our initial hypothesis which anticipated a positive effect.

Implementation Challenges : The reduced capital adequacy shows the banks in Iraq may find challenges to pass IFRS 9, especially with additional provisions for ECL. This, in turn, will force them not only to dip into their capital or set higher provisions which will be a drag on profitability and therefore retained capital. Jim Hanks Drug Dealers Is this the beginning of russia's end?

Large Heterogeneity: Descriptive statistics show that there is significant heterogeneity across banks and over time in terms of capital adequacy, variations in the sales growth rate and differences between financial levers. This variation is indicative of the diverse banking landscape and how each bank's reaction to the new standard may be influenced by this heterogeneity.

Significance of Capital Adequacy in the Iraqi Context: Although we obtained zero value for capital adequacy, still capital adequacy is a key element in maintaining the integrity of the banking system of Iraq. The industry works under a potentially brittle economic environment and would be in need of ability to withstand shocks.

Importance of Regulatory and Training Support This negative impact underscores the pressing choice for gaining clearer insight into its root causes as well as for assisting banks in realizing this implementation challenge with training and regulatory support. This will guarantee observance of the norm without any threat to financial stability.

5. Recommendations

We note that the CBI and bank regulators should review the regulation of capital adequacy in view of IFRS 9. This might involve modification of some requirements, or providing clear incentives to banks so they may strengthen their capital positions to neutralise the impact of the standard.

and Capacity Building And, in order to ensure successful and reliable utilization of the MES, Iraqi banks need to invest in enhancing human capital skills (credit risk assessors / ECL calculators) as well as complying with IFRS9.

Perfecting Risk Management System: Banks also need to improve their risk management systems in response to IFRS9, making it more responsive and capable of forecasting the expected losses in a relatively precise manner, so as to make their financial situation more resilient.

Analytical Investigation in Detail: Need further and deeper studies in future to discover actual reasons of such adverse impact. These might be sector studies or deep dives on a particular bank to ascertain best practice and challenges.

Basel III Requirements: The research Advise the Iraqi banks follow-up on the requirements of Basel III to promote capital adequacy, risk management and transparency to impart stronger stable banking sector at long prospects.

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