The Impacts of New Financial Instrument Accounting Standards on Chinese Commercial Banks

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Abstract. On March 31, 2017, the Ministry of Finance revised and issued three new financial instrument accounting standards including *Accounting Standards for Enterprises No.22- Recognition and Measurement of Financial Instruments*. The banks of China's A and H stocks have implemented the new standards since January 1, 2018. From January 1, 2021, the scope of implementation of the standards covers all non-listed commercial banks. The new financial instrument standards have undergone great changes in the classification and impairment treatment of financial assets, which is bound to have a profound impact on Chinese commercial banks. This article analyzes the impacts of new standards on Chinese commercial banks from the aspects of financial asset classification and measurement, impairment, credit risk management, profit and earnings management. Finally, the paper puts forward several suggestions and measures on the system and model construction, credit policy and post-loan risk management and talent training, in order to facilitate banks smooth the transition to the new standards.

Keywords: New financial instrument accounting standards; Commercial banks; Impact.

1. Introduction

Since its implementation, IAS39 has been criticized by many financial report users because of its excessive subjectivity, complexity and risk lag. The IASB promulgated IFRS9 in July 2014, which became effective on January 1, 2018[1]. IFRS9 has made major adjustments in the classification and measurement of financial instruments, impairment of financial assets and hedge accounting, etc., completely replacing IAS39. Drawing lessons from IFRS9 and combining with China's actual needs, the Ministry of Finance revised and issued the *Accounting Standards for Enterprises No. 22- Recognition and Measurement of Financial Instruments* and other three standards related to financial instruments on March 31, 2017. It requires companies which are listed both domestically and abroad and listed overseas to implement the standards on January 1, 2018[2]. Non-listed companies that implement the Accounting Standards for Business Enterprises shall implement the standards on January 1, 2021.

The revision of financial instrument standards not only affect the financial asset management and financial presentation of enterprises, but also determine the healthy development of the entire financial market and the effectiveness of financial supervision. As the financial assets of commercial banks account for a large proportion of their types, and their composition is extremely complex, their financial asset accounting, external statements, risk management and other aspects will inevitably be impacted by the new financial instrument standards. For commercial banks, it is particularly important to be familiar with the changes in the new standards as soon as possible and to achieve a smooth transition from the old standards to the new standards. Therefore, based on the comparison between the old standards and the new standards, this article focus on the impacts of the new standards on the classification of financial assets, impairment, credit risk management, profits and earnings management of commercial banks and put forward relevant suggestions and measures. This article hopes that this will help China's commercial banks to further understand and effectively implement new standards, strengthen risk management, and promote the stable development of China's financial market.

2. Major changes in the new financial instrument standards

2.1 Changes in the classification of financial assets

(1) The classification criteria are more objective and clear. Under the old standards, the four types of financial assets have their own classification standards. Therefore, the classification is complex and lacks logic, and there is a certain degree of subjectivity. In the new standards, all financial assets adopt a unified and objective classification standard, namely "business model" and "contractual cash flow characteristics of financial assets". This has obvious advantages in improving the objectivity of classification and promoting the comparability of accounting information.

(2) The "four classifications" are simplified to "three classifications". According to the old standards, financial assets are divided into four categories based on holding intentions and other criteria: financial assets at fair value through profit or loss, held-to-maturity investments, loans and accounts receivable, and financial assets available for sale. Based on the "business model" and "contractual cash flow characteristics of financial assets", the new financial instrument standards divide financial assets into three categories: Financial instruments reported at amortized cost, Fair value through other comprehensive income (FVOCI), Fair value through profit or loss (FVPL)[3].

(3) The rules for reclassification of financial assets have changed. On the one hand, the scope of reclassification of financial assets has expanded. The old standards stipulate that FVPL shall not be reclassified from the other three categories, and held-to-maturity investments and financial assets available for sale can be reclassified when certain conditions are met; while the three types of financial assets under the new standards can all be reclassified. On the other hand, although the new standards have relaxed the scope of assets for reclassification, they set more stringent conditions for reclassification, and there must be objective and reliable evidence that the business model has indeed changed. The special case is that the financial assets designated as FVPL at the initial classification and the non-trading equity instruments designated as FVOCI shall not undergo subsequent reclassification [4].

2.2 Changes in the treatment of financial asset impairment

Under the old standards, different types of financial assets adopt different impairment models, which is too complicated. The accounting treatment of the old standards adopts the “incurred loss method”, and the impairment provision is made only when objective evidence of impairment of financial assets is found on each balance sheet date, regardless of the credit losses that may occur in the future. The time point is lagging and it is unable to reflect the credit risk status of financial assets in full and in time [5].

The new standards require the provision of impairment for AC and FVOCI (debt) categories, and a unified impairment model for all financial assets that need to be provided for impairment. The impairment method has been changed from the "incurred loss method" to the "expected loss method", and future expected credit losses need to be considered. Therefore, financial assets that have not been credit-impaired may also need to be provided for impairment. At the time of initial recognition, financial assets must be accrued for 12-month expected credit losses, and accrual for the entire duration of credit losses when credit risks increase significantly or there is objective evidence of impairment. As a result, the scope of impairment of assets has been expanded, the timing of impairment withdrawals has been advanced, and financial asset impairment reserves can be made more timely and in full, so that the value of financial assets can be prudently revealed and the risks of financial assets can be effectively prevented.

3. The impacts of new financial instruments standards on China's commercial banks

3.1 Impact on the classification and measurement of financial assets

The new standards use "financial asset contract cash flow characteristics" and "business model" as the two major criteria for the classification of financial assets. Therefore, the test of "financial asset contract cash flow characteristics" (referred to as the SPPI test) and the execution of the business model test have become a major challenge faced by commercial banks. The business system of a commercial bank needs to add the functions of SPPI test and business model test for related classification.

Regardless of the classification of special financial assets, the approximate correspondence between "four categories" and "three categories" is shown in Table.1.

Table.1. Correspondence between "four categories" and "three categories"

<table>
<tr><th colspan="2">Four categories</th><th>Three categories</th><th>Measurement basis</th></tr>
<tr><td colspan="2">Held-to-maturity investments</td><td rowspan="2">Financial instruments reported at amortized cost</td><td rowspan="2">Amortized cost</td></tr>
<tr><td colspan="2">Loans and accounts receivable</td></tr>
<tr><td rowspan="2">Financial assets available for sale</td><td>Debt instruments</td><td>Fair value through other comprehensive income (FVOCI)</td><td rowspan="3">Fair value</td></tr>
<tr><td>Equity instruments</td><td rowspan="2">Fair value through profit or loss (FVPL)</td></tr>
<tr><td colspan="2">Financial assets at fair value through profit or loss</td></tr>
</table>

Most of the held-to-maturity investments and accounts receivable meet the classification conditions of AC and are still measured at amortized cost, with no major changes in accounting. Long-term debt investment is classified as a new account title "debt investment." However, some investments in loans and accounts receivable, and held-to-maturity investments may not pass the SPPI test or business model test and will be classified as FVPL; another part may be reclassified as FVOCI, and the new account title is " Other debt investments"[6]. Both are measured at fair value, and the accounting changes greatly. In addition, the changes in the accounting titles and accounting of original financial assets available for sale are more complicated.

The valuation range of financial assets of commercial banks has expanded. As far as commercial banks are concerned, how to use professional judgments to select appropriate valuation techniques, how to reasonably obtain market information and use relevant valuation parameters to build valuation models are all challenges [7]. Commercial banks need to value a wide range of financial assets. Therefore, the refined design of valuation system, the introduction of differentiated market data, the construction of valuation model and the analysis and adjustment of valuation results are all very difficult and require high specialization.

3.2 Impact on impairment of financial assets

The new standards use "expected credit loss model" to replace "incurred loss model" to calculate impairment of financial assets. The scope of application of the model is expanded, and the amount of impairment will increase. In addition, unimpaired financial assets also need to confirm expected credit losses, without the existence of objective evidence of impairment. Therefore, under the new standards, the base of financial asset impairment will be greatly increased, and the amount of impairment provision will also increase. For commercial banks, the largest proportion of financial assets are customer loans and advances, so the amount of loan impairment provisions will have the most obvious increase. However, in the subsequent years of the implementation of the new standards, the change of the amount of impairment may be slowed down due to the advance of the time point of impairment provision.

In addition, under the new standards, the data content required for the measurement of expected credit losses in 12 months and the whole period of existence is more complex, requiring more relevant information as support. Most commercial banks use risk parameter model to calculate expected credit losses, while relevant risk parameters need to be speculated by commercial banks through internal rating, historical data analysis or expert judgment. At the same time, risk parameters must be adjusted prospectively by taking into account relevant forward-looking information. Therefore, the accuracy of judging the future economic situation is directly related to the reasonable degree of risk parameter setting, and also related to the accuracy of financial asset impairment calculation.

3.3 Impact on credit risk management

Under the "expected loss model" of the new standards, commercial banks need to divide financial assets into three stages according to the credit risk status and measure expected credit losses respectively. Therefore, credit risk management is directly related to the stage division and impairment provision of financial assets, which is crucial for commercial banks. The "three-stage method" is based on the change of credit risk, that is, the relative value rather than the absolute value of credit risk.

Commercial banks need to rebuild the "three-stage" credit risk management system, and the classification of credit risk will rely more on forward-looking information and macro information. Among the three stages, the first and second stages are divided according to whether the credit risk of financial assets has increased significantly since the initial recognition. In measuring this standard, commercial banks need to consider a variety of reasonable and evidence-based information, not only the characteristics of the borrower and the quality of the loan itself. This promotes the comprehensiveness and timeliness of credit risk management of commercial banks and improves the ability to prevent and respond to credit risk [8].

3.4 Impact on profits

The impact of the new standards on commercial banks' profits mainly comes from the increase of FVPL and the change of the impairment model.

On the one hand, after financial assets are changed from "four categories" to "three categories", FVPL increases. This means that the base of financial assets measured at fair value increases, and the change of fair value is recorded in the "fair value change gains and losses", which directly affects the income statement of commercial banks in the current period, and the uncertainty of profit fluctuations increases[9]. On the other hand, the application of "expected credit loss model" will increase the amount of impairment provision to a certain extent in the short term, so as to decrease the net profit. But in the long run, the expected credit loss method only advances the time of impairment provision, which can smooth the fluctuation of the impact of impairment loss on profits to a certain extent. When financial markets are more buoyant, the value of financial assets is less inflated because expected credit losses have been recognized. When the financial market is depressed, the expected credit losses are recognized in advance, which does not increase many asset impairment losses instantly, thus smoothing out profit fluctuations.

3.5 Impact on earnings management

Financial assets available for sale and loan loss provision adjustment are two main means of earnings management in commercial banks. The financial assets available for sale and loan loss provisions under the new standards are greatly impacted, so the earnings management of commercial banks will also be affected.

Under the old standards, commercial banks tend to include equity investments in financial assets available for sale, so as to adjust current profits by disposing of them and achieve the effect of smoothing profits of each period. Under the new standards, most of the equity instruments available for sale are classified as FVPL, and the change of fair value directly affects the income statement. In addition, the criteria for reclassifying financial assets under the new standards are also stricter. Therefore, the new standards greatly limit the possibility of earnings management by commercial banks through financial assets available for sale.

When the profit target deviates from the expectation, commercial banks can adjust the profit properly by controlling the provision of loan impairment reserve or turning it back, so as to smooth the profit of each period. Under the new standards, the division of financial asset impairment stage leaves commercial banks certain manipulation space, and the division of different stages also determines different impairment provisions, which may achieve the purpose of earnings management. In addition, the setting of risk parameters also depends on the subjective consideration and judgment of commercial banks, which also increases the possibility of earnings management of commercial banks [10].

4. Suggestions

4.1 Improve system and model construction

The new standards put forward high requirements for the information system construction of commercial banks and the effective docking between the systems as well as the construction and optimization of models. First of all, commercial banks should update relevant modules of SPPI test and business model test in the business system and establish their own standardized judgment and classification process. Secondly, they need to adjust the setting of accounts and the selection of accounting methods in the accounting system according to the new standards. Commercial banks should also strengthen the construction and optimization of accounting valuation model and actively collect and obtain the information needed for valuation. In addition, it is necessary to strengthen the construction of expected credit loss model, strictly implement the three-stage classification standard of credit risk, and reasonably set up the necessary risk parameters [11].

Therefore, the business system, financial system and risk management system of commercial banks should be upgraded to some extent. Commercial banks should strengthen the interconnection and docking among various systems, realize the rapid collection and sharing of information, and improve the efficiency and quality of commercial banks' business, finance and risk management activities.

4.2 Detailed loan policy and improve post-loan risk management

Commercial banks can measure the degree of credit risk of each loan in a more precise way to assist the implementation of refined loan policies of commercial banks, so as to implement differentiated pricing strategies for loan businesses with different risk levels. In addition, the guarantee policy, collection policy and risk monitoring means for each transaction can also be detailed to ensure the high quality and low risk of loan business as much as possible.

Due to the introduction of the "three-stage" division of credit risk into the expected credit loss model, commercial banks must continuously monitor the changes of credit risk in order to make accurate judgment or adjustment of credit risk characteristics in time. This requires commercial banks to obtain timely regulatory, market environment and other macro information, and combined with relevant information to make a comprehensive judgment. In addition, post-loan risk management should gradually shift from post-control to pre-prevention, which can give more timely and positive warning of potential risk information, so that commercial banks can make risk response and resolution measures as soon as possible.

4.3 Strengthen training of professionals

After all, there are many new breakthroughs in the implementation of the new standards. It is crucial that business personnel, financial personnel and risk management personnel can quickly adapt to the changes of the new standards. Therefore, it is necessary to strengthen the training of professional personnel and improve their professional quality.

First of all, the business personnel should make accurate judgment on the business model to connect the financial personnel to the classification of financial assets; Financial personnel should grasp the changes of accounting and impairment treatment as soon as possible, and in-depth study of accounting valuation work; Risk management personnel should have the ability to analyze macro information and forward-looking information and master the construction of risk models. All kinds of personnel should also have an understanding of other professional knowledge in order to achieve effective communication and collaboration among departments.

5. Conclusions

The impacts of the new financial instrument standards on China's commercial banks is mainly reflected in the following aspects: the changes of financial assets classification and measurement affect the accounting of commercial banks; The changes of the impairment treatment have an impact on the impairment provision of commercial banks, and put forward higher requirements for related impairment parameters and information; Credit risk management more detailed and timely; Commercial banks' profit volatility and earnings management methods are also affected. In order to deal with the impacts of new financial instrument standards, commercial banks should make some efforts in system and model construction, credit policy and post-loan risk management and personnel training.

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