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Enhancing Financial Risk Management for a Brokerage Firm in Indonesia under the New Regime of IFRS 9 and the COVID-19 Pandemic

Introduction

International Financial Reporting Standard 9 (IFRS 9) of the International Accounting Standards Board pertains to a new set of rules on how financial institutions should classify their financial assets, and how they should measure the expected credit loss (ECL) that could arise from the impairment of their financial assets, contracts and hedging.

This article spotlights the initial implementation of IFRS 9 in an Indonesian brokerage during the year when the COVID-19 pandemic devastated many businesses, large and small, and how this created the momentum to improve financial risk management in the country's securities companies across the board.

Proper implementation of IFRS 9 requires the firm's accountant to put together documentation that clearly explains the nature of each financial asset, meaning the underlying transactions that created such assets, prior to developing internal processes to measure the impairment of the firm's financial assets.

Steps to Ensure Proper Implementation of IFRS 9

2020 was the year in which Indonesia adopted the implementation of IFRS 9, bringing about a radical change in how financial institutions measure the ECL due to the impairment of their financial assets. This article will focus on a stock brokerage. Its main intention is to provide information about the nature of the financial assets that need to be assessed using the IFRS 9 framework. The complex nature of IFRS 9, combined with the first year of its implementation, mean that Indonesian public accountants lack experience auditing the implementation of IFRS 9 in a brokerage firm and encouraged me to share some of my insights in this article.

Certain steps need to be carried out in the correct order to ensure proper implementation of IFRS 9. Four of those steps can be described as follows.

The first step is to make a complete list of all the financial assets on the brokerage firm's balance sheet. Special attention should be given to the types of transactions that occupy the biggest portion of the balance sheet.

The second step is to understand the transactions underlying each financial asset. To completely understand each financial asset it is crucial to carefully map the business process of each underlying transaction. It is also helpful to check with the local regulator for guidance to ensure that every single transaction by the brokerage is approved by the regulator.

The third step is to correctly classify each type of transaction according to IFRS 9's Classification of Financial Assets and to calculate the probability of default (PD) rate, the loss given default (LGD) rate, and the macroeconomic variables, and finally to put together allowance for expected loss for the impairment of financial assets. One commonly chosen macroeconomic variable is the stock market index (e.g., in Indonesia, the Jakarta Stock Exchange Composite Index).

The fourth and final step is to create a proper documentation with all the information regarding steps 1 to 3. This document should serve the company as a living document that records all the types of financial assets that are created over time and to record continuing refinements in the methodology employed to calculate PD, LGD, and the macroeconomic variables.

Consideration of IFRS 9 for Brokerage Firms' Basic Transactions

This article does not intend to provide information for every possible type of financial asset that could sit on the balance sheet of an Indonesian brokerage. Rather, it covers only the most common financial assets, the two most basic financial assets that are derived from the two most basic transactions conducted by brokerage firms.

Accounts receivable from stock brokerage clients

For a brokerage firm, accounts receivable are not necessarily loans extended to clients. This financial asset appears on the balance sheet due to the time-lag between when a transaction occurs and when the settlement of the transaction occurs. In Indonesia, stock purchases on the regular market are settled in two business days after the transaction.

In the case when a client has sufficient funds in their brokerage account, the firm will still book an account receivable entry because of this two-day settlement regulation. There is no financial risk whatsoever for the brokerage firm during those two days.

In the case when a client does not have enough funds but does have enough stocks in its portfolio, this portfolio can serve as collateral for the brokerage firm to give credit facility for the client's stock purchases. Prior to this, the firm needs to decide the haircut rate that it will apply to every single stock in the client's portfolio. The haircut rate serves as a buffer to protect the firm from the possibility of a decreasing stock price between the transaction date and the settlement date. The size of this loan should not exceed the total value of every single stock in the portfolio after taking into account the haircut rate. With this type of transaction, the account receivable will be recorded by the firm, starting from the client's stock purchase date. The company will give the client two days to settle the purchase amount by transferring funds to its fund account.

Sometimes a client may sell some stocks in their portfolio one day after they make a stock purchase. In this case, the

account receivable at T+1, actually no longer represents an amount due from a customer, because the firm also has a certain amount due to the same customer.

The uniqueness of accounts receivable in brokerage firms needs to be fully grasped and well documented or the PD rate and LGD rate will be calculated based on inaccurate assumptions. In my experience, public accountants tend to adopt the approach they use when auditing banks, i.e., they calculate the PD rate on each bucket of days-past-due to come up with the PD rate for loans to a customer, as normally seen in banks. This error can be avoided if the brokerage has a well-documented process mapping of client transactions, to give the public accountant or auditor a clear understanding about the nature of its accounts receivable.

One unique feature of IFRS 9 when calculating the ECL of financial assets is to take into consideration the trading limit when a customer does not have cash to make a stock purchase. The nature of this kind of credit limit is totally different from the credit limit on investment loans or on working capital loans. Accountants and auditors should be very cautious when considering the credit limit in brokerage firms not to apply the model they apply in banks to calculate ECL.

After the World Health Organization formally gave the name COVID-19 to the novel corona virus on February 11, 2020, it did not take many weeks for Indonesia's blue chip stocks to start collapsing. The stocks of most of Indonesia's best firms had a price-to-book value below one. Soon, this exceptionally low price encouraged dormant stock traders to activate their accounts and start using their savings to buy the undervalued stocks. This phenomena was followed by another: People started working from home and using online meeting platforms (with Zoom and Google Meet being the most popular). Now, people have a lot of time at home to learn about stock trading and to monitor the movement of their stocks' prices. Zoom and Google Meet have also played an important role in disseminating information via online training from securities companies, as well as in providing information from the Chief Financial Officers (CFOs) and investor relations officers in public companies.

As the result of the rapid growth in trading value every month since February 2020, securities companies have seen the accounts receivable from their brokerage clients skyrocket. This will have a serious impact on the allowance for ECL under

IFRS 9.

Margin facility extended to retail investors to purchase stocks

It is a common practice for brokerage firms to extend loans called margin facility to their clients to purchase stocks. In order for clients to get this facility, they need to provide a certain kind of collateral. In Indonesia, the commonly accepted collateral is either cash or stock. Indonesia Stock Exchange currently trades more than 700 different stocks. Of these, 155 stocks can serve as collateral for margin facility. This type of facility is usually given to clients with three-month tenor.

The current regulation in Indonesia requires all brokerage firms to maintain a minimum of IDR250 billion Adjusted Net Working Capital (ANWC) on their balance sheets in order to offer margin facility to their clients to purchase any stock available on the stock exchange. Firms with ANWC less than IDR250 billion may only use margin facility to purchase stocks of the top 45 blue chip companies, known as LQ45.

The quality of this type of financial asset, is highly dependent on the value of the underlying stocks. When the value of the asset drops due to a decrease in the market price of the stock, the quality of the financial assets is impaired.

The challenge is to decide which macroeconomic variables should be included in calculating the ECL. One view is to adopt the Market Composite Index.

One should be careful when adopting a pragmatic approach to calculating the past correlation between stock price and the market composite index, e.g., the Indonesia Composite Index, and applying a statistical approach to predict the value of the stock in the future by regressing the current stock price with the forecast of Market Stock Index, where the forecast of the market index itself is based on the consensus of equity market analysts. This pragmatic approach has been criticized by those who argue that predicting the future price of a stock by regressing it with future prediction of Stock Market Index has weak scientific basis and can result in an erroneous prediction of the future price of a stock. Predicting a stock's price in the future, requires in-depth fundamental analysis of the stock and of how it is impacted by future economic conditions.

Enhanced Financial Risk Management as the Byproduct of IFRS 9 Implementation

The sheer complexity of IFRS 9 has pushed the CFOs and Chief Controllers of brokerage firms to take into consideration the economic variables that can influence the sufficiency of their allowance for ECL. They also need to understand all variations of transactions, how each of those variations has led to past defaults and what proportion of the default the company recovered.

Now, more than ever before, CFOs and Chief Controllers need to ensure that they have robust documentation regarding the nature of each transaction and its features so that the brokerage firm can build an accurate model complete with scenarios of variables that influence the value of the assets in the future.

There are a couple of things that need to be monitored by a brokerage firm as part of managing financial risk, in relation to the implementation of IFRS 9.

1) Monitoring the limit on credit for purchasing stocks that comes from existing stock in the client's portfolio

One feature of IFRS 9 is the necessity to calculate and provide a certain allowance for ECL based on the amount of such credit that the brokerage firm provides to its clients.

2) Monitoring the macroeconomic variables that can affect the ECL

These macroeconomic variables should be carefully chosen with the assistance of the brokerage's chief economist and head of equity research. In addition to inflation and market interest rates, the most common factors reflecting the state of the economy, other macroeconomic variables that influence different sectors of the economy should also be considered. Stocks in plantations will be influenced by different macroeconomic variables than stocks in property or infrastructure sectors. Once the macroeconomic variables have been chosen, the brokerage firm should from time to time recalibrate its formula to assess the suffi-

ciency of its allowance for ECL. This is a new practice that was unknown to financial controllers of brokerage firms prior to 2020.

3) Monitoring the variables used in calculating haircuts (or discounts) on stocks used as collateral

The concept of assessing ECL by calculating the LGD rate was foreign to both the CFO and the financial controller of brokerage firms prior to implementing IFRS 9. Now that they have to take into account the LGD rate, it is crucial to identify which stocks they are willing to accept as collateral for margin facility. Calculating the LGD rate requires the CFO to predict the future value of those stocks. Needless to say, nobody knows for sure what the price of a stock will be in the future. However, it is imperative that under the IFRS 9 regime brokerage firms put their best effort into perfecting their ECL calculation formula by perfecting their effort to predict the price of stock one year in the future.

4) Monitoring the behaviour of customers who are suspected as nominees of other traders

One of the main challenges in the stock market is the existence of traders who are in fact nominees of other traders. These traders conduct their stock purchasing and selling, not out of their own judgement, but based on the direction and orders from other traders. There may be many different underlying intentions for such transactions, but one thing for sure is that every brokerage firm must prevent any concerted actions conducted by two or more parties to influence the price of a stock. A deep understanding of the nature of stock trading, gained during the implementation of IFRS 9 will help financial controllers to spot such occasions and notify the CFO.

When the major portion of a brokerage company's income comes from stock brokerage, it cannot downplay the importance of employing statistical expertise. Calculating the PD and LGD rates, incorporating the macroeconomic variables as well as putting together the ECL allowance for the credit limit were not common tasks for a brokerage firm prior to 2020. Expertise in statistical analysis is crucial when a brokerage firm implements IFRS 9.

In a normal year, one would expect that initial implementation of IFRS 9 would strain the allowance for financial asset impairment, due to the new way of calculating the PD rate and the LGD rate, and the way the credit limit is incorporated in calculating ECL. The sudden occurrence of the COVID-19 pandemic has created the unprecedented situation of an economy devastated due to people's health conditions. This unusual cause of financial asset impairment might not happen again in the future. Therefore, any PD rate or LGD rate that was derived from historical data should be applied cautiously in calculating the ECL of financial assets in 2021. This matter should be acknowledged in the accounting and risk management manual when implementing IFRS 9 for the first time in 2020.

Conclusion: a CFO's Insights

In 2020 the CFO of a brokerage firm in Indonesia had to steer its financial strategy for surviving the recession caused by the COVID-19 pandemic and the unprecedented catastrophic economic events. More over the CFO:

- gained valuable new insights into the firm's financial assets in conjunction with implementing IFRS 9 at the same time.
- became thoroughly steeped in every single aspect of the firm's financial assets because of the need to clearly explain to the auditor of their 31 December 2020 financial statement the methods used to calculate the ECL due to the impairment of financial assets as defined by IFRS 9.
- convinced the auditor that the firm's team created a robust model to assess the ECL from impairment of financial assets based on proper calculation of the PD and LGD rates and appropriate choice of macroeconomic variables.
- recognized that the sudden increase in stock trading by retail customers in



Indonesia during the second half of 2020 was driven significantly by the fear of missing out on the opportunity of a future stock price rebound.

In 2021, if the COVID-19 vaccine program is successful, the economy will be back to normal. When this happens, retail customers who entered the stock market without sufficient knowledge about investing and trading and used a margin facility for their stock purchase will start having difficulty to retain the value of their stock portfolio. This, in turn, will adversely impact the calculation of the PD rate for the securities companies where they have their trading accounts.

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He is a member of the Indonesian Accountant Association as well as the Indonesian Association of Securities Companies. He holds an Investment Manager Representative License, an Underwriter Representative License, and a Broker-Dealer Representative License issued by the Indonesia Financial Services Authority.