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Business Ethics and The Law of Contract

Barbara Mescher

It is essential for business managers to be able to rely upon the performance of promises made in legally binding contracts. This article examines the role of business ethics in contract performance. It demonstrates that the law alone is not enough to ensure performance because the law is a narrower field than business ethics. Law has drawn upon the broader discipline, ethics, to form the foundation of the law. Ethics is about moral standards, and ethical philosophies explain moral standards. Business ethics has applied these philosophies to business. The law and business ethics are two different disciplines although they are at some points integrated and at others complementary. An appreciation of the relationship between applied ethics and the law is necessary to assist managers to appreciate that business ethics is as much part of business as is commercial law. This is particularly the case in the law of contract. This article encourages managers to embrace the principles of business ethics and engage in ethical decision-making as a necessary part of their business. Trust and honesty are ethical principles and they are basic elements of all business operations, especially entry into contracts. 8

IAS 39 and the Practice of Loan Loss Provisioning Throughout Australasia

Nigel Finch

This paper examines the response of a sample of Asian banks to the recognition of loan loss provisions before, during and after the Global Financial Crises. Drawing on empirical data from 2006 through 2009, this paper focuses on the level of loan loss provisioning undertaken by the banks, with a view to generating insights into the effectiveness of the approach to loan impairment and provisioning prescribed by IAS 39 – Financial Instruments: Measurement and Recognition. Given that the focus of impairment decision making under IAS 39 is historically oriented rather than future oriented, we argue this may result in the diminution in the decision usefulness of the content of bank financial statements in the face of imminent, though not yet manifested economic distress. Despite mounting evidence that substantial portions of the globe's financial and economic fabric lay in a state of severe distress, our analysis of the financial disclosures of the sample of Asian banks shows a picture at odds with this larger reality. We argue that this response is shaped by the requirements of the newly introduced accounting standard and that a broadening of the legitimate sources of evidence upon which loan impairment recognition decisions may be based pursuant to IAS 39 should be a matter of priority. 13

Risk-Based Approaches to Combating Financial Crime

David Chaikin

The traditional method of combating financial crimes such as money laundering is the use of prescriptive legislation. A new idea is that risk concepts may be applied to understanding the phenomenon of money laundering and in devising strategies to minimise money laundering. In Australia, financial institutions have implemented a Risk-Based Approach to money laundering by devising Anti-Money Laundering/Counter-Terrorism Financing programs. Financial institutions are expected to identify the risks of money laundering arising from their customers, products/services, distribution/delivery systems and the countries/jurisdictions in which they operate or do business. They are also required to analyse the risks in relation to their specific circumstances and apply a risk management strategy to reduce those risks. The challenge is that Risk-Based Approaches can only minimise the potential risks of money laundering at best; they cannot provide any guarantee that money launderers will not use the product or services of a financial institution. The money laundering risk remains even in circumstances where a financial institution complies with the regulatory requirements and applies best practice in risk management. Nevertheless, the Risk-Based Approach offers financial institutions the most efficient method of setting priorities and allocating resources to combat money laundering.... 20

EDITORIAL

As 2009 draws to a close, we observe the dust settling over a business landscape startled by the impact of the global financial crisis. While commentators continue to reflect on and debate the causes and flow-on consequences from this unique confluence of events, many would agree that poor ethical behaviour, inadequate disclosure and an absence of appropriate risk measurement among banks were factors that contributed to the extreme erosion in value and unprecedented regulatory intervention.

In this issue, the Journal of Law & Financial Management provides a collection of timely articles examining business regulation issues in the wake of the global financial crises including ethics, banking disclosure and risk measurement among financial institutions.

Firstly, Barbara Mescher examines the role of ethics in contract performance and highlights critical issues associated with the application of ethical principles in business. Next, Nigel Finch examines the issues and trends in loan loss provisioning among Australasian banks. This study examines the practice of loan impairments and provisions over the period 2006 to 2009, a period designed to capture the impact of the global financial crises and interrogate the banks' response to this event. Finally, David Chaikin provides a commentary on the use and effectiveness of risk-based models in financial institutions. In response to many challenges such as money laundering and terrorism financing, financial institutions are expected to apply 'best practice' strategies designed to reduce the risk of being exposed to these financial crimes; however, as Chaikin illustrates, money laundering risks often remain even where financial institutions comply with regulatory requirements and best practices in risk management.

Tyrone M Carlin & Guy Ford

Sydney, December 2009.

IAS39 AND THE PRACTICE OF LOAN LOSS PROVISIONING THROUGHOUT AUSTRALASIA

By Nigel Finch*
University of Sydney

Abstract

This paper examines the response of a sample of Asian banks to the recognition of loan loss provisions before, during and after the Global Financial Crises. Drawing on empirical data from 2006 through 2009, this paper focuses on the level of loan loss provisioning undertaken by the banks, with a view to generating insights into the effectiveness of the approach to loan impairment and provisioning prescribed by International Accounting Standard (IAS) 39 – Financial Instruments: Measurement and Recognition. Given that the focus of impairment decision making under IAS 39 is historically oriented rather than future oriented, we argue this may result in the diminution in the decision usefulness of the content of bank financial statements in the face of imminent, though not yet manifested economic distress. Despite mounting evidence that substantial portions of the globe's financial and economic fabric lay in a state of severe distress, our analysis of the financial disclosures of the sample of Asian banks shows a picture at odds with this larger reality. We argue that this response is shaped by the requirements of the newly-introduced accounting standard and that a broadening of the legitimate sources of evidence upon which loan impairment recognition decisions may be based pursuant to IAS 39 should be a matter of priority.

Keywords: Impairment, Loan loss provision, Banking, IFRS

Perhaps the greatest impression forged into the minds of policy makers and regulators in the wake of the global financial crisis which began to make its presence felt from 2007 has related to the pace of deterioration in conditions. In July 2007, soon after the term 'subprime' had begun to take on a sinister connotation in minds around the world, US Federal Reserve Chairman Bernanke forecast that losses relating to these loans might amount to US$100 billion. Not long would pass before the International Monetary Fund (IMF) would be pronouncing that the losses stemming from the burgeoning banking and credit markets crisis would not be measured in the billions, but in the trillions.

In April 2008, the IMF ventured the view that losses would exceed US$1 trillion (IMF, 2008). By October of that year, this had been revised to a total loss estimate of US$1.4 trillion (IMF, 2008). The best estimate as at January 2009 stood at US$2.2 trillion (IMF, 2009), notwithstanding the fact of massive and coordinated fiscal and monetary stimulus responses by central banks and governments around the world as they attempted to prevent financial market meltdown contaminating the globe's real economy. By October 2009, the estimate was dramatically revised with a further increase of some 50 per cent reaching US$3.4 trillion (IMF, 2009).

Though the implications of the crisis are global in their reach and significance, the financial complexes of the United States and Europe have been at the vortex of the storm. It is these institutions which had the largest direct exposures to subprime and similar loan classes and to complex structured financial products (Duffie, 2008). In turn, it was US and European financial institutions which suffered the greatest proportion of direct loan impairments and security write-downs stemming from the crisis, with Asian banks figuring in the direct loss equation only to a relatively minor extent (IMF, 2008).

However, the shocks to liquidity, the cost of credit and to economic growth induced by the financial crisis have implications for financial institutions throughout Asia, even though to a large extent Asian institutions have not been in the vanguard of the first wave of loss exposure. Consequently, drawing on empirical data from 2006 through 2009, this paper focuses on the position of a sample of Asian banks and their responses throughout this economic storm.

In particular, this paper focuses on the level of loan loss provisioning undertaken by the banks included in the research sample, with a view to generating insights into the effectiveness of the approach to loan impairment and provisioning prescribed by IAS 39—Financial Instruments: Measurement and Recognition. In achieving this objective, the paper is structured as follows. Section 2 discusses relevant elements of the IAS 39 approach to loan impairment and some of the challenges and difficulties inherent with the application of this approach. Section 3 sets out an overview of the data sample drawn upon and the testing methods applied to the empirical evidence drawn upon for the purposes of the study. Section 4 contains an overview and discussion of the results, while Section 5 contains some conclusions.

Loan Impairment

Provisioning for loan losses plays a key role in determining the makeup and thus transparency and representational faithfulness of banks' balance sheets. Decisions made with respect to loan loss provisioning also have the capacity to wield substantial influence over the level of volatility and cyclicality evident in reported bank earnings. Because the loan impairment provision decision is one of such potentially high significance, it has been associated with considerable controversy (Ahmed et al, 1999; Laeven and Majnoni, 2003; Fonseca and González, 2008).

For example, in jurisdictions where regulations permit the exercise of substantial discretion in the generation of loan loss impairment provisions and charges, there have

been many thoroughly documented cases of systematic under-provisioning in the face of adverse financial climates, with the result of substantial degradation in the decision usefulness of information sets contained in bank financial statements (Genay, 1998).

The literature also documents how the discretion has been exercised to smooth capital requirements and earnings (Beattie et al, 1995). This has been documented across a wide variety of jurisdictions and across extended timeframes (Wahlen, 1994; Kim and Kross, 1998; Ahmed et al, 1999). Further, there is evidence to the effect that in many cases, provisioning levels have failed to change either at the same rate as, or contemporaneous with changes in the size of bank loan portfolios (Jimenez and Saurina, 2005).

From a regulatory perspective, discretion in loan impairment provisioning may provide greater capacity to build up substantial buffers against deterioration in credit quality prior to the emergence of objectively verifiable data evidencing the existence of impairment in individual loans or portfolios of loans (Borio and Lowe, 2001). This forward-looking, uncertainty-tolerant approach to loan impairment provisioning lies in stark contrast to the dominant flavour of contemporary accounting rules on the subject, which emphasise the primacy of objective and verifiable evidence over future-oriented conjecture (Glover et al, 2005).

In effect, according to a typical prudential regulatory management approach impairment provisions are best characterised as anchored within an expected losses model, while the contemporary accounting rulemaking approach to loan impairment provisioning is anchored within an incurred loss tradition.

This incurred loss approach is clearly reflected in the provisions of IAS 39, which governs loan impairment accounting. Paragraph 58 of the standard directs entities reporting in accordance with the standard to assess, at each reporting date, whether there is any objective evidence consistent with the proposition that an individual loan or portfolio of loans is impaired.

Objective evidence of impairment is said to spring from the occurrence of some loss event or events[1] which individually or together impact on the value of the estimated future cash flows attributable to a loan or portfolio of loans. Examples of events giving rise to evidence of impairment include evidence of financial distress on the part of an obligor, delinquency or default in relation to interest or principal payments and the entry into or high probability of entry into bankruptcy or financial reorganisation[2].

IAS 39, Paragraph 59(f)(ii), also countenances the view that impairment may be established where national or local economic conditions that correlate with defaults, including increases in unemployment rates, decreases in property prices or adverse changes in business conditions identifiable as touching on borrowers from a geographic region where loans have been advanced are visible.

While this may appear to be an invitation to include a forward-looking dimension into the loan impairment assessment decision, the better view is that the focus of impairment decision making in IAS 39 is historically oriented rather than future oriented. Paragraph 59 of the standard emphasises this form of focus, stipulating that 'losses expected as a result of future events, no matter how likely, are not recognised'.

The insistence on the availability of objective evidence of impairment threaded through IAS 39 raises a paradox of potential significance. On the one hand, discretion in the framing and timing of provisions and write-downs has been the source of a notorious capacity for financial statement manipulation. Consequently, the removal of the capacity to create provisions or write down the value of assets by reason of impairment without a requirement that such decisions be grounded in some objectively verifiable evidentiary base should improve the transparency and reliability of financial statement data (Briloff, 1972; Mulford and Comiskey, 2002; Tweedie, 2007).

On the other hand, a strict insistence on a historically grounded approach to the loan impairment recognition decision may result in the exclusion from financial statements of potentially value relevant information. The financial crisis which commenced in 2007 rapidly resulted in a self-reinforcing cycle of deleveraging (Brunnermeier, 2008).

This form of deleveraging is typically associated with severe restrictions on credit availability and systematic decreases in asset prices and material economic contraction (Minsky, 1993). In turn, these phenomenon have been demonstrated to be strongly associated with higher default rates and lower recovery rates subsequent to default (Altman and Pasternack, 2006). Further, there is strong evidence of substantial synchronisation between key global economies on dimensions including output, investment, credit availability and to a lesser extent, consumption (Claessens et al, 2008).

Thus, while the epicentres of economic stress resulting from the financial crisis lay in the United States and Europe, material roll on consequences for Asian markets and economies were highly likely from the outset (Lim, 2008; Lim, 2009). Yet IAS 39 is constructed on the premise that notwithstanding the likelihood of losses stemming from future events, recognition of value diminution is not possible until the loss trigger events themselves have occurred and verifiable evidence of these is available.

Although IAS 39 countenances the possibility of having regard to macroeconomic conditions which have been shown to correlate with increased loan losses and defaults (for example increases in unemployment rates or property price declines), the standard stipulates that any macro-economic referents drawn upon as a basis for justifying loan impairment decisions should be closely related to the location of the loan portfolios the subject of potential default.

The practical consequence of this stipulation is that macro economic indicators relating to jurisdictions other than those in which bank loan portfolios are held may not be taken into account in the determination of loan impairment, even in circumstances where the variables in question are likely to represent leading indicators of future conditions in the jurisdiction in which the loan portfolios are domiciled.

One consequence of this apparent deficiency may be the inducement of upwards bias in reported earnings in periods immediately prior to the commencement of economic adjustments and more savage adjustment of earnings and balance sheets during the period of economic adjustment (Cavallo and Majnoni, 2001). Whether this conjectured information content deficiency might arise in the types of circumstances contemplated above is the basis of the empirical analysis within this paper.

Given the likelihood of macro-economic contagion effects (IMF, 2009), the position of Asian banks in the immediate wake of the US and European financial crisis represents a useful setting in which to test the proposition that the IAS 39 focus

on existing local or national verifiable evidence relating to loan impairment might lead to a reduction in the decision usefulness of the content of bank financial statements. The approach taken and data drawn upon for the purpose of developing insights into this proposition are discussed in the next section.

Data and Methods

The conjecture investigated in this paper is that the approach taken to the issue of loan impairment in IAS 39 may result in the diminution in the decision usefulness of the content of bank financial statements in the face of imminent and actual economic distress. Evidence useful for the purposes of testing the validity of this conjecture was gathered from a sample of Asian[3] bank financial statements spanning 2006 through 2009. Given the robust performance of the global and Asian macro-economy during 2006, that year provides a baseline against which data from later periods during which financial and economic distress was becoming increasingly evident may be compared (IMF, 2006; IMF, 2007; IMF, 2008).

The data drawn upon for the purposes of the analysis was based on a sample consisting of 10 Asia based banks and was constructed by selecting two large banks from each of Australia, China, Hong Kong, Malaysia and Singapore. These jurisdictions represent countries that have each adopted International Accounting Standards (IAS) over the focal period for the analysis (2006 to 2009 inclusive). Further, each of these countries plays a significant economic role in the Asia-Pacific region (RBA, 2008).

To increase the comparability and consistency of data drawn upon for the purposes of the analysis only banks with an equivalent 'AA' or 'A' institutional credit rating were included in the final research sample. With the exception of Malaysian domiciled banks, Standard and Poor's institutional credit ratings were used to assess the banks financial credentials.

The conjecture investigated in this paper is that the approach taken to the issue of loan impairment in IAS 39 may result in the diminution in the decision usefulness of the content of bank financial statements in the face of imminent and actual economic distress.

Table 1 — Details of Research Sample

Bank Name	Country	Credit Rating	Month End	Assets (USD$ million)
Commonwealth Banking Group	Australia	AA	June	499,089
ANZ Banking Group	Australia	AA	September	416,267
China Construction Bank Corporation	China	A	December	1,330,996
Industrial & Commercial Bank of China	China	A	December	1,670,596
The Hong Kong and Shanghai Banking Corporation	Hong Kong	AA	December	2,421,843
Hang Seng Bank	Hong Kong	AA	December	101,926
Malayan Banking Berhad	Malaysia	A	June	87,784
Public Bank Berhad	Malaysia	A	December	57,641
OCBC Group	Singapore	A	December	126,126
DBS Group	Singapore	AA	December	180,803
n=10			**Total Assets**	**6,893,071**

Analysis was undertaken on a whole of sample and credit rating based sub-sample basis. Arithmetic and weighted average measures of key variables of interest were calculated for each of 2006, 2007, 2008 and 2009 years. For the purpose of the calculation of weighted mean measures, loan to equity ratios, return on equity and provision expense to equity were weighted on the basis of bank total equity expressed as USD equivalent, provision expense to loans was weighted on the basis of total outstanding loans expressed as USD equivalent, while provision expense to profit was weighted on the basis of net profit before tax expressed as USD equivalent. The results and a discussion thereof are set out in the next section.

Results and Discussion

Over the period reviewed, there was some evidence of variation in the financial performance (as measured by return on equity). Whole of sample equity weighted ROE increased from 19.0 per cent in 2006 to 18.3 per cent in 2009. Decomposition of the data into credit rating based sub samples revealed that 'A' rated banks reported substantial increases in ROE over the period reviewed (up from an equity weighted mean of 17.7 per cent in 2006 to 26.2 per cent in 2009), while on the same measure, 'AA' rated banks exhibited a decline in performance from 22.3 per cent in 2006 to 16.0 per cent in 2009[5].

Contemplating the pattern of divergence evident between the return on equity experience of the 'A' rated and 'AA' rated banks, the data portrays the operating climate of the 'A' rated organisations included in the research sample as essentially benign. This is especially evident when viewing the data through the whole of sample equity weighted lens, which depicts a consistent but gradual increase in bank ROE across the period reviewed. The ROE results data are set out in Table 2, below.

Table 2 — ROE (before tax)

	FY 2006			FY 2007			FY 2008			FY 2009		
	"A" Bank (n=5)	"AA" Banks (*n=5*)	Total sample (*n=10*)	"A" Bank (n=5)	"AA" Banks (*n=5*)	Total sample (*n=10*)	"A" Bank (n=5)	"AA" Banks (*n=5*)	Total sample (*n=10*)	"A" Bank (n=5)	"AA" Banks (*n=5*)	Total sample (*n=10*)
Min.	15.30%	14.30%	**14.30%**	15.10%	13.10%	**13.10%**	10.80%	9.30%	**9.30%**	6.50%	8.00%	**6.50%**
Max.	25.10%	30.60%	**30.60%**	30.10%	38.00%	**38.00%**	25.70%	30.80%	**30.80%**	28.60%	28.60%	**28.60%**
Spread	9.80%	16.40%	**16.40%**	15.00%	24.90%	**24.90%**	14.90%	21.50%	**21.50%**	22.10%	20.60%	**22.10%**
Median	19.90%	21.40%	**20.60%**	22.70%	26.60%	**23.30%**	20.30%	17.00%	**18.70%**	27.70%	13.50%	**17.00%**
Wtd Avg.	17.70%	20.00%	**19.00%**	22.00%	19.80%	**20.80%**	23.50%	12.30%	**17.50%**	26.20%	11.10%	**18.30%**
Avg.	20.20%	22.30%	**21.30%**	22.60%	24.50%	**23.50%**	18.50%	18.60%	**18.50%**	20.90%	16.00%	**18.40%**

The data also reveals that from a leverage perspective, the composition of sample bank balance sheets changed comparatively little over the period studied, with the loan to equity ratio hovering at close to eight times between 2006 and 2009 with a slight increase of only 80 basis points on a weighted average basis. Again, nothing in this data suggests the presence of balance sheet shocks or other substantial dislocations to either the makeup of the balance sheet or the underlying businesses of the organisations scrutinised.

Table 3 — Loan to Equity Ratio

	FY 2006			FY 2007			FY 2008			FY 2009		
	"A" Bank (n=5)	"AA" Banks (*n=5*)	Total sample (*n=10*)	"A" Bank (n=5)	"AA" Banks (*n=5*)	Total sample (*n=10*)	"A" Bank (n=5)	"AA" Banks (*n=5*)	Total sample (*n=10*)	"A" Bank (n=5)	"AA" Banks (*n=5*)	Total sample (*n=10*)
Min.	4.09%	4.05%	**4.05%**	4.24%	4.59%	**4.24%**	4.33%	5.21%	**4.33%**	3.82%	4.44%	**3.82%**
Max.	8.60%	12.86%	**12.86%**	9.95%	13.10%	**13.10%**	11.72%	13.82%	**13.82%**	11.54%	14.84%	**14.84%**
Spread	4.51%	8.81%	**8.81%**	5.72%	8.51%	**8.87%**	7.40%	8.61%	**9.50%**	7.72%	10.40%	**11.02%**
Median	7.80%	7.55%	**7.68%**	7.34%	7.25%	**7.31%**	7.93%	7.83%	**7.88%**	8.54%	8.83%	**8.62%**
Wtd Avg.	7.63%	8.24%	**7.98%**	7.21%	8.22%	**7.77%**	7.52%	8.50%	**8.04%**	8.25%	9.25%	**8.78%**
Avg.	7.29%	8.63%	**7.96%**	7.27%	8.93%	**8.10%**	7.98%	9.11%	**8.54%**	7.96%	8.89%	**8.43%**

Over the period studied, whole of sample loan impairment expenses exhibited growth when measured as a proportion of outstanding loans, equity and before tax profits (for summaries of these results, see Tables 4, 5 and 6, respectively). However, within sample analysis revealed the existence of ostensibly anomalous patterns. On a weighted average basis, 'A' rated banks recognised lower loan impairment costs than 'AA' rated banks in each year reviewed.

Further, the level of loan impairment charges relative to pre-tax profit recorded by 'A' rated banks fell in each successive year from 2006 through 2008, before reverting back to 2006 levels, whilst 'AA' rated banks exhibited the opposite pattern rising over the entire period. The discrepancy between weighted and unweighted impairment measures suggests that larger banks undertook higher impairment cost charge-offs than smaller banks.

If balance sheet size is a useful proxy for wider international loan portfolio mix exposure, one potential interpretation of the data is that by 2007 and 2009, banks included in the research sample were increasing their recognition of loan impairment in relation to ex-Asian loan exposures, but not to the same extent in relation to intra-Asian loan portfolios.

Taking a whole of sample perspective, it is difficult to reconcile the impairment cost data produced within Asian bank financial statements with the cataclysmic events in the global banking and finance system across 2007 and 2009. On an equity weighted basis, loan impairment costs as a proportion of outstanding loans increased by only 2 basis points between 2006 and 2009 and only 60 basis points when compared to equity over this period.

Over the same period of time, a very substantial proportion of the equity of the US and European commercial banking complex vapourised, with massive injections of public funds and de facto nationalisations being key components of the suite of response measures put in place in a bid to combat the crisis. None of the flavour of this is evident in the content of the financial statements of the Asian banks studied. This appears consistent with the conjectures in relation to the impact of IAS 39 discussed above.

Table 4 — Provision Expense to Loans

	FY 2006			FY 2007			FY 2008			FY 2009		
	"A" Bank (n=5)	"AA" Banks (n=5)	Total sample (n=10)	"A" Bank (n=5)	"AA" Banks (n=5)	Total sample (n=10)	"A" Bank (n=5)	"AA" Banks (n=5)	Total sample (n=10)	"A" Bank (n=5)	"AA" Banks (n=5)	Total sample (n=10)
Min.	0.00%	0.11%	**0.00%**	0.05%	0.14%	**0.05%**	0.12%	0.11%	**0.11%**	0.39%	0.19%	**0.19%**
Max.	0.85%	1.22%	**1.22%**	0.84%	1.76%	**1.76%**	0.64%	1.92%	**1.92%**	1.02%	1.26%	**1.26%**
Spread	0.85%	1.11%	**1.21%**	0.78%	1.62%	**1.71%**	0.52%	1.81%	**1.81%**	0.64%	1.07%	**1.07%**
Median	0.67%	0.16%	**0.36%**	0.53%	0.23%	**0.47%**	0.53%	0.54%	**0.54%**	0.58%	0.71%	**0.68%**
Wtd Avg.	0.73%	0.81%	**0.78%**	0.70%	1.15%	**0.97%**	0.59%	1.38%	**1.03%**	0.50%	1.04%	**0.80%**
Avg.	0.55%	0.35%	**0.45%**	0.49%	0.58%	**0.54%**	0.44%	0.68%	**0.56%**	0.66%	0.74%	**0.70%**

Table 5 — Provision Expense to Equity

	FY 2006			FY 2007			FY 2008			FY 2009		
	"A" Bank (n=5)	"AA" Banks (n=5)	Total sample (n=10)	"A" Bank (n=5)	"AA" Banks (n=5)	Total sample (n=10)	"A" Bank (n=5)	"AA" Banks (n=5)	Total sample (n=10)	"A" Bank (n=5)	"AA" Banks (n=5)	Total sample (n=10)
Min.	0.0%	0.6%	**0.0%**	0.2%	1.5%	**0.2%**	1.4%	0.7%	**0.7%**	2.9%	1.2%	**1.2%**
Max.	6.0%	8.4%	**8.4%**	5.7%	11.3%	**11.3%**	4.9%	13.1%	**13.1%**	6.9%	10.0%	**10.0%**
Spread	6.0%	7.8%	**8.4%**	5.5%	9.8%	**11.1%**	3.5%	12.4%	**12.4%**	4.0%	8.9%	**8.9%**
Median	5.0%	1.4%	**3.3%**	3.9%	2.5%	**3.2%**	4.0%	3.4%	**3.7%**	4.8%	8.5%	**5.3%**
Wtd Avg.	5.3%	6.1%	**5.8%**	4.7%	8.4%	**6.8%**	4.2%	10.3%	**7.4%**	4.0%	8.7%	**6.4%**
Avg.	4.2%	2.7%	**3.4%**	3.6%	3.9%	**3.8%**	3.2%	5.3%	**4.3%**	4.7%	6.3%	**5.5%**

Table 6 — Provision Expense to Net Profit Before Tax

	FY 2006			FY 2007			FY 2008			FY 2009		
	"A" Bank (n=5)	"AA" Banks (n=5)	Total sample (n=10)	"A" Bank (n=5)	"AA" Banks (n=5)	Total sample (n=10)	"A" Bank (n=5)	"AA" Banks (n=5)	Total sample (n=10)	"A" Bank (n=5)	"AA" Banks (n=5)	Total sample (n=10)
Min.	0.1%	1.8%	0.1%	1.4%	2.6%	1.4%	10.3%	1.8%	1.8%	19.2%	14.0%	14.0%
Max.	29.4%	32.4%	32.4%	22.3%	41.6%	41.6%	16.5%	49.5%	49.5%	50.4%	84.7%	84.7%
Spread	29.3%	30.6%	32.3%	20.9%	39.0%	40.2%	6.2%	47.8%	47.8%	31.1%	70.7%	70.7%
Median	18.1%	6.4%	11.7%	14.6%	8.8%	13.3%	12.2%	19.3%	13.4%	30.1%	40.7%	31.4%
Wtd Avg.	22.94%	22.87%	22.9%	18.0%	28.4%	23.6%	13.0%	37.5%	22.7%	23.1%	56.7%	33.9%
Avg.	17.2%	10.4	13.8%	13.4%	15.2%	14.3%	12.9%	22.7%	17.8%	31.3%	45.9%	38.6%

Over and above considerations relating to returns, leverage and impairment cost experience, a further noteworthy feature of the data appears to be the increasing sensitivity to loan impairment charges exhibited by the sample banks over time. Whereas the average profit sensitivity to a 10 basis point increase in loan impairment costs stood at 3.69 per cent in 2006, this had grown to 5.70 per cent by 2009 (see Table 7).

Table 7 — Sensitivity of Profit to a 10 BPS Increase in Provisions

	FY 2006			FY 2007			FY 2008			FY 2009		
	"A" Bank (n=5)	"AA" Banks (n=5)	Total sample (n=10)	"A" Bank (n=5)	"AA" Banks (n=5)	Total sample (n=10)	"A" Bank (n=5)	"AA" Banks (n=5)	Total sample (n=10)	"A" Bank (n=5)	"AA" Banks (n=5)	Total sample (n=10)
Min.	-4.90%	-5.29%	-5.29%	-3.43%	-4.92%	-4.92%	-10.81%	-7.42%	-10.81%	-11.10%	-11.03%	-11.10%
Max.	-2.40%	-1.70%	-1.70%	-2.81%	-1.19%	-1.19%	-2.44%	-1.60%	-1.60%	-2.84%	-2.14%	-2.14%
Spread	2.51%	3.59%	3.59%	0.62%	3.74%	3.74%	8.37%	5.82%	9.21%	8.25%	8.89%	8.96%
Avg.	-3.66%	-3.73%	-3.69%	-3.19%	-3.70%	-3.44%	-4.64%	-4.87%	-4.75%	-4.83%	-6.56%	-5.70%

This suggests the capacity for more rapid deteriorations in reported earnings and in balance sheet conditions in the event that the Asian economic cycle experiences a material downturn in response to the 2007 and 2008 banking crisis. Were this to occur, the historically focused approach to impairment recognition stipulated by IAS would drive a schism between the information content of financial statements produced by Asian banks in a period contemporaneous with economic distress in leading Ex-Asia economies and in some subsequent period when the effect of that distress had left a more material imprint on the fortunes of Asian economies themselves.

Conclusion

By 2007 and certainly by 2008, it was clear that substantial portions of the globe's financial and economic fabric lay in a state of severe distress. Yet an examination of the financial disclosures by a series of large Asian domiciled banks shows a picture at odds with this larger reality. As the global crisis worsened through 2007 and 2008, the response of Asian banks was muted.

No doubt an element of the explanation of the benign signal implicit in the Asian bank financial disclosures lies in their lower direct exposures to troubled asset classes and complex structured products than was the case in their US and European counterparts (Mosharian, 2009).

However, it also seems strongly arguable that the impairment recognition procedures stipulated by IAS 39 represent an element of any explanation for the patterns evident in the data. This should represent a matter of concern. If one of the objectives of the IFRS regime is to allow reporting entities (in this case banks) to produce financial disclosures which are of greater assistance to users by way of being constructed on a foundation of more decision useful information, it may be that this objective is being poorly served by the current approach to evidence set out in IAS 39.

Unless the pan-Asian economic complex has substantially decoupled from the US and European economies (and there is very little evidence consistent with this proposition), the study of Asian bank financial disclosures reported in this paper strongly suggests that a broadening of the legitimate sources of evidence upon which loan impairment recognition decisions may be based pursuant to IAS 39 should be a matter of priority. A failure for reconsideration of this matter should be of substantial concern in those jurisdictions which have yet to adopt International Financial Reporting Standards (IFRS) but which are actively considering such a transition over the medium term.

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Notes

[1] IAS 39, Paragraph 59.

[2] See IAS 39, paragraph 59. The list discussed above is not exhaustive, and IAS 39 provides further examples.

[3] Australia is included in Asia for the purposes of this paper.

[4] In 2005, Standard and Poor's and Rating Agency Malaysia entered into an affiliation agreement whereby the two firms have coordinated their analytical and business development activities in Malaysia which included Standard & Poor's sharing its global rating expertise and analytical criteria with Rating Agency Malaysia (RAM).

[5] This decline was dominated by higher charge offs by one bank in particular, HSBC. It is likely that these were in turn driven by that organisations comparatively high exposure to US markets, and in particular, to US mortgage markets.