THE BANK STATEMENT

Q1 2013 NEWSLETTER

KPMG

cutting through complexity

"Although a useful credit management tool, forbearance can potentially obscure the credit quality of a bank's portfolio because it can improve the arrears statistics even though the underlying credit risk may remain constant. Hence, forbearance has increasingly become a focus of attention of regulators, analysts and other stakeholders."

Abhimanyu Verma,
Financial Services,
KPMG in Canada

THE NEW PROPOSED IMPAIRMENT MODEL AND REGULATORY FOCUS ON FORBEARANCE

Welcome to the Q1 2013 issue of our quarterly banking newsletter in which we provide updates on IFRS developments that directly impact banks and consider the potential accounting implications of regulatory requirements.

Highlights:

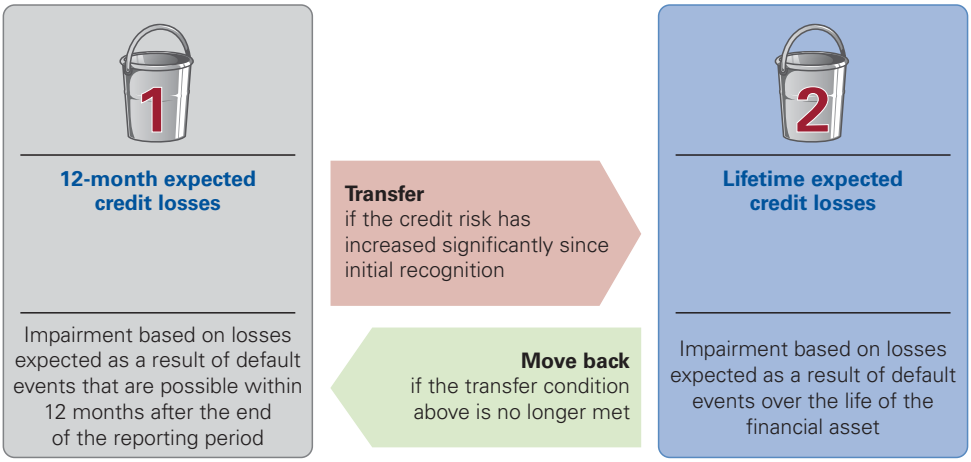
- The IASB's long-awaited revised proposals on the **impairment** of financial assets have been re-exposed for public comment, whereas the issuance of the final **general hedging** standard will be delayed until the IASB has completed further outreach – see pages 2 and 3.
- The IASB has proposed a limited exception to IAS 39 and IFRS 9 to require existing **hedging relationships** to continue if a **novation** of a derivative contract that was not contemplated in the original hedging documentation meets specific criteria – see page 3.
- Regulators are focusing on **forbearance** arrangements. We explore the related accounting and disclosure requirements – see page 7.
- Amendments to IFRS 9 on **classification and measurement** can impact banks' regulatory ratios. We consider some areas of potential interaction between these amendments and certain elements of the **Basel III regulatory framework** – see page 12.

IASB proposes a new 'expected loss' impairment model

In March 2013, the IASB issued its exposure draft ED/2013/3 *Financial Instruments: Expected Credit Losses* (the ED), which forms part of the IASB's project to replace the financial instruments standard (IAS 39 *Financial Instruments: Recognition and Measurement*). The proposals would replace the current 'incurred loss' approach with an 'expected loss' model.

New model at a glance

As the diagram below shows, the proposed model uses a dual measurement approach. Generally, from initial recognition financial assets would have a loss allowance equal to 12-month expected credit losses. Financial assets would be transferred from the '12-month expected loss' category to the 'lifetime expected loss' category if their credit risk has increased significantly since initial recognition. Judgement would be needed to determine whether the transfer of an asset between categories is required because the proposals do not define the term 'significant increase in credit risk'. Expected credit losses would be measured as the present value of cash shortfalls.



The new model would apply to:

- all financial assets recognised on-balance sheet and measured either at amortised cost or mandatorily at fair value through other comprehensive income (FVOCI);
- certain loan commitments and financial guarantees; and
- lease receivables within the scope of IAS 17 *Leases* and the tentative decisions in the IASB's leases project.

The key judgements in applying the new model would be the estimation of:

- expected credit losses; and
- the point at which there is a significant increase in credit risk since initial recognition of the asset.

The proposals do not prescribe a specific method for calculating expected losses. It is likely that the method applied will vary depending on the type of asset, the information available and the bank's existing credit systems.

Special rules would apply to purchased or originated credit-impaired financial assets. The ED also includes guidance on interest recognition and accounting for modifications of financial assets.

Impact on banks

The proposed new methodology is expected to have a significant impact on banks because systems and processes would need to be amended to accommodate the new model. Banks may also need to consider the impact of proposals on equity, covenants and key performance indicators (KPIs). Furthermore, sourcing additional information for the proposed extensive disclosure requirements could be complex as well as resource- and time-consuming. Banks need to take steps in assessing the extent of the possible impact now, because preparing for the far-reaching impacts of these changes may require significant effort.

It should be noted that the IASB observed that in many jurisdictions regulated financial institutions already calculate a 12-month loss rate that is similar to the proposals in the ED. Although differences between the regulatory requirements and the proposals in the ED would need to be identified, quantified and addressed appropriately, implementation of the model proposed in the ED would be less costly.

IASB's and FASB's proposals not converged

Although the IASB and the FASB had been jointly developing a so-called 'three-bucket' impairment model, following constituent feedback, the FASB issued its own proposals in December 2012. The FASB proposals are based on a single measurement requirement – lifetime expected credit losses.

Next steps

The comment period for the ED ends on 5 July. The FASB has extended its comment deadline to 31 May.

For details of KPMG's publication on the ED – *New on the Horizon: Financial instruments – Expected credit losses* – see page 18.

General hedging – New tentative decisions taken and further outreach planned

In January, the IASB considered feedback that it had received on its general hedging review draft. In a significant change, the IASB decided to consider foreign exchange basis spreads, which are present in derivatives such as currency swaps, as a 'cost of hedging' rather than as ineffectiveness. The IASB also decided that, on transition to the new general hedging standard, certain existing 'own use' contracts may be designated as at fair value through profit or loss (FVTPL) on an 'all-or-nothing' basis for all similar contracts.

In addition, the IASB clarified some of the interaction between existing macro hedging practices under IAS 39 and the requirements of the proposed general hedging standard. It seems that many existing macro cash flow hedging strategies would be able to operate in a similar manner through designation under the general hedging requirements of IFRS 9 Financial Instruments. There was a fear that many of these strategies would not be permitted under the new standard. The IASB also confirmed that an entity using the scope exception for macro fair value hedge accounting would apply all (applicable) hedge accounting requirements in IAS 39.

In a surprise move, the IASB decided to postpone issuing a final general hedging standard for a limited time in order to conduct further outreach.

Proposed relief for hedge accounting if derivatives are novated to a central clearing counterparty

As we have reported previously, laws and regulations on over-the-counter (OTC) derivatives are changing in several jurisdictions, requiring many of them to be novated to a central counterparty (CCP). The *European Market Infrastructure Regulation* and the *Dodd-Frank Wall Street Reform and Consumer Protection Act* are some examples. Many derivatives that are, or may be, subject to these requirements have been designated in hedging relationships.

In May 2012, the US Securities and Exchange Commission's (SEC) Office of the Chief Accountant provided guidance in a letter to the International Swaps and Derivatives Association (ISDA) about whether implementation of certain provisions of the *Dodd-Frank Act* (the Act) that

relate to OTC derivatives would affect a company's hedge accounting. The guidance stated that in principle SEC staff would not object to a continuation of the existing hedging relationships under US GAAP in certain limited circumstances.

To provide a similar relief to IFRS reporters, in February 2013 the IASB issued exposure draft ED 2013/2 *Novation and Continuation of Hedge Accounting,* proposing a limited-scope amendment to IAS 39 and IFRS 9 that would require a continuation of the existing hedging relationship if the novation was not contemplated in the original hedging documentation and meets the following criteria:

- it is required by laws and regulations;
- it results in a CCP becoming a new counterparty for each of the parties to the novated derivative; and
- the changes to the terms of the derivative are limited to those necessary for the novation.

The IASB's quick consideration of the issue is likely to be welcomed by banks. However, the exemption appears to be restrictive because it does not seem to cover situations in which:

- novation is carried out in anticipation of an expected future requirement; or
- laws or regulations change in a way that incentivises but does not require banks to novate derivatives to CCPs.

Also, the amendment does not seem to contemplate the diversity of ways in which jurisdictions may implement the central clearing of derivatives. For example, we understand that in some jurisdictions only entities that are 'clearing members' of the CCP may enter into derivative contracts directly with the CCP as counterparty. Other entities would be required to novate derivatives to a clearing member (rather than directly with the CCP), and then the clearing member would transact with the CCP.

Due to the widespread effect of the issue, the IASB wishes to introduce the amendment quickly and so has limited the comment period for the exposure draft to 30 days. In the meantime, banks documenting new hedging relationships may wish to state that their intention is for the hedging relationship to continue if the hedging derivative is subsequently novated.

For details of KPMG's publication on the limited amendments to IAS 39 and IFRS 9 in this area – *In the Headlines: Continuing hedge accounting after derivative novations* – see page 18.

IASB clarifies how the proposed revenue recognition model would apply to financial services

In January, the IASB and the FASB (the Boards) continued their deliberation of exposure draft ED/2011/6 *Revenue from Contracts with Customers* (the revenue ED), focusing on certain topics of particular relevance to the banking industry.

Change for some asset managers in accounting for performance fees

The Boards observed that, at present, many asset managers recognise revenue either:

- progressively over time by estimating the fair value of the consideration at the end of each reporting period; or
- at the end of the performance period when all contingencies are resolved.

By contrast, the proposed guidance would require all entities to exercise judgement and recognise revenue as and when they become confident that there will not be a significant revenue reversal. This would be a new test and a new threshold. In some cases, it may result in revenue being deferred towards the latter portion of the performance period, as and when the asset manager becomes confident of the outcome. It may also affect margins if the related compensation expense is recognised throughout the period.

The Boards also agreed that no changes should be made to the revenue ED's proposals on contract costs. Asset managers would assess all of the facts and circumstances in each asset management arrangement when accounting for up-front commission costs.

Financial services contracts

The revenue ED applies to all contracts with customers, other than those within the scope of IFRS 4 *Insurance Contracts,* IFRS 9 and IAS 17, and certain non-monetary exchanges. The Boards clarified that if a contract includes both a financial instrument and services, then the financial instrument accounting requirements would be applied first in allocating the transaction price; the revenue proposals would be applied to the residual, which may be measured as having no attributed value. For example, banks may provide treasury services to clients including lock box services, cheque clearing or account reconciliations. Fees related to these services may be reduced or eliminated depending on the level of deposits that the client maintains in the bank. In such circumstances, the accounting for the deposit would not be changed, and therefore any fees would be allocated to the services provided. The Boards decided to improve the application guidance for financial services contracts by including an example.

Next steps

In February, the Boards completed their substantive redeliberations of the revenue ED, although the staff may bring any remaining and any new 'sweep' issues to a future IASB meeting. The stated target deadline for the new IFRS is Q2 2013.

For details of KPMG's publication on recent developments in revenue recognition in financial services within the scope of the revenue project – *Revenue Newsletter: Application Issues*, January 2013 – see page 18.

Written puts on non-controlling interests

In May 2012, the IFRS Interpretations Committee published a draft interpretation on the accounting for put options written by a parent on the shares of its subsidiary that are held by non-controlling-interest shareholders (NCI puts). The draft interpretation would require all changes in the measurement of the NCI put liability to be recognised in profit or loss (P&L).

As part of its redeliberations, the Interpretations Committee expressed the view that better information would be provided if NCI puts were measured on a net basis at fair value, consistent with derivative treatment. Consequently, before finalising the draft interpretation, it decided in January 2013 to ask the IASB to reconsider the requirements in IAS 32 *Financial Instruments: Presentation* for put options and forward contracts written on an entity's own equity. In March, the IASB tentatively decided to reconsider these requirements, and in particular whether put options and forwards written on an entity's own equity should be measured 'gross' or 'net'.

The discussions on this issue will take place at a future meeting.

Interpretations Committee completes deliberations on accounting for levies

In May 2012, the Interpretations Committee published a draft interpretation on the accounting for levies, other than income taxes, imposed by governments. The comment period ended in September.

In January 2013, the Interpretations Committee continued its deliberations and tentatively decided that:

- levies should be defined as transfers of resources imposed by governments on entities in accordance with laws and/or regulations, other than:
  - levies that are within the scope of other standards (such as income taxes within the scope of IAS 12 *Income Taxes*); and
  - fines or other penalties imposed for breaches of laws and/or regulations;

- the final interpretation should address the accounting for the liability to pay a levy but should refer to other standards to decide whether levy costs are recognised as assets or expenses;
- the final interpretation should address the accounting for levies with minimum thresholds. In this respect, the Interpretations Committee tentatively concluded that for a levy that is triggered if a minimum activity threshold is achieved, the obligating event that gives rise to a liability to pay a levy is the achievement of the minimum activity threshold; and
- the same recognition principles should be applied to the interim financial statements as are applied in the annual financial statements.

In its March meeting, the Interpretations Committee decided not to re-expose the interpretation and agreed to publish the levies interpretation subject to minor drafting amendments.

The interpretation will be submitted to the IASB for ratification at a future IASB meeting.

Applicability of IFRS 7 offsetting disclosure requirements to condensed interim financial statements – Still unclear

The amendments to IFRS 7 *Financial Instruments: Disclosures – Offsetting Financial Assets and Financial Liabilities* are effective for annual periods beginning on or after 1 January 2013. The Interpretations Committee discussed in March the applicability of the amendments to condensed interim financial statements and noted that it is unclear whether the disclosures should be presented in such statements and, if so, whether the presentation should be on a recurring basis or only in the first year in which the disclosure requirements become effective.

The Interpretations Committee asked the staff to consult the IASB to establish its initial intent; the feedback is expected at a future meeting.

Interpretations Committee refrains from finalising the tentative decision on negative yields

In January, the Interpretations Committee discussed the implications of the economic phenomenon of negative effective interest rates for the presentation of income and expenses. It expressed concerns over finalising the tentative agenda decision[1] because it could have unintended consequences on the classification of financial assets in accordance with IFRS 9. In light of these concerns, the Interpretations Committee refrained from finalising the tentative agenda decision until the IASB has completed its deliberations on limited amendments to IFRS 9 on classification and measurement.

Insurance project

KPMG has released recent publications about the insurance project. See page 18 for further details.

1 Previously, in its September 2012 meeting, the Interpretations Committee considered that in light of the existing IFRS requirements an interpretation was not necessary, and tentatively decided not to add the issue to its agenda.

> "Transparency in explaining forbearance practices and related impairment considerations are key to ensuring that users understand their impact on a bank's risk exposure and performance."

Users seek transparency in reporting forbearance arrangements

Editorial by Abhimanyu Verma, Financial Services, KPMG in Canada, sharing his insights on key accounting considerations surrounding loan renegotiation and forbearance practices

The prolonged period of challenging economic conditions has resulted in a significant increase in the number of borrowers facing financial difficulties. This in turn has led to greater use by banks of forbearance in their effort to prevent defaults and limit their credit losses. Commonly used forbearance techniques include payment holidays, capitalisation of arrears, reduction of interest rates, conversion to an interest-only basis, term extensions, debt-to-equity swaps and covenant waivers. Forbearance can often benefit both banks and borrowers because it can support borrowers through the period of difficulties and maximise recoveries for banks.

However, although a useful credit management tool, forbearance can potentially obscure the credit quality of a bank's portfolio because it can improve the arrears statistics even though the underlying credit risk may remain constant. Hence, forbearance has increasingly become a focus of attention of regulators, analysts and other stakeholders. Transparency in explaining forbearance practices and related impairment considerations are key to ensuring that users understand their impact on a bank's risk exposure and performance.

The Financial Stability Board's Enhanced Disclosure Task Force (EDTF), in its October 2012 report *Enhancing the Risk Disclosures of Banks* (the EDTF report), recommends that banks explain the nature and extent of their loan forbearance and modification practices and how they affect the reported level of impaired or non-performing loans. In December, the European Securities and Markets Authority issued a public statement, *Treatment of Forbearance Practices in IFRS Financial Statements of Financial Institutions* (the ESMA report). The ESMA report discusses accounting and disclosures relating to forbearance. Regulators in various jurisdictions have issued their own guidance – e.g. the Financial Services Authority (FSA) in the UK and the *Autorité des Marchés Financiers* (AMF[2]) in France.

We consider below some of the accounting issues relating to forbearance activities.

Accounting considerations

The key accounting issues associated with forbearance activities are:

- determination of whether the loan (or another financial asset) subject to the renegotiated terms should be derecognised and a new loan with new terms recognised in its place; and
- recognition and measurement of impairment.

Forbearance activities also impact credit risk disclosure.

The term 'forbearance' is not defined by IFRS but regulators may apply their own definition. For example, the ESMA report defines forbearance as: "when a lender decides to modify the terms and conditions of a loan or debt security if the borrower is unable to meet them because it is in financial difficulty".

Derecognition

The first accounting question that often arises on a modification of a financial instrument is whether the instrument should be derecognised and a new one with the renegotiated terms recognised in its place.

IAS 39 does not contain specific guidance for the accounting treatment of financial assets that have been modified. The general guidance on the derecognition of financial assets requires an assessment of whether contractual cash flows from financial assets have 'expired'. It is

2 AMF: the stock market regulator in France

unclear whether the renegotiation of contractual terms amounts to an expiry of the original financial asset.

In 2012, the Interpretations Committee discussed the derecognition of modified financial assets within the context of a narrow fact pattern submitted to it. It noted that when applying the requirements of IAS 8 *Accounting Policies, Changes in Estimates and Errors* because of the absence of explicit guidance in IAS 39, judgement is required to develop and apply an accounting policy. When doing so, consideration is given to the requirements in IFRS dealing with similar and related issues. In the case of the derecognition of a modified financial asset, this would lead to consideration of the explicit guidance in IAS 39 on the derecognition of a modified financial liability.

The IAS 39 guidance on the derecognition of financial liabilities requires a financial liability to be derecognised if its financial terms have been modified substantially. It states that a modification is substantial if the present value of the cash flows under the new terms (including any fees paid or received) is at least 10 percent different from the present value of the remaining cash flows of the original financial liability (both discounted using the original effective rate of the unmodified instrument).

In our view, if a financial asset has been replaced by a new financial asset, then the holder should perform a quantitative and qualitative evaluation of whether the cash flows of the two instruments are substantially different. If they are substantially different, then the contractual cash flows of the original financial asset should be deemed to have expired.

In view of the lack of specific guidance in IAS 39 relating to the derecognition of modified financial assets, banks will have to exercise judgement to determine if assets subject to forbearance should be derecognised.

Impairment

Assets subject to forbearance may already have an associated impairment allowance. For example, a retail customer may have missed a number of contractual payments before they approach their bank to ease the contractual terms. However, some assets may have no impairment allowance at the time of the modification and a question then arises about whether the fact that a modification is taking place is of itself evidence of impairment. Then, there is a question about how an impairment of a modified financial asset should be measured.

Under IAS 39, an asset is considered to be impaired only if objective evidence indicates that one or more events ('loss events'), occurring after its initial recognition, have an effect on the estimated future cash flows of that asset. As forbearance is usually undertaken because a borrower is in financial difficulties, it is likely that the conclusion will be reached that there is objective evidence of impairment. The ESMA report states that forbearance practices are an objective indicator of impairment under IAS 39. It expects that, if there is forbearance, then entities will consider the impact on the estimated future cash flows of the financial asset, applying a heightened level of scepticism about whether the full contractual cash flows will be recovered.

Once objective evidence of impairment has been identified in respect of a modified financial asset, the next step is measuring the impairment. In our view, the requirement to assess the impairment applies irrespective of whether the modification of the existing terms leads to derecognition of a loan subject to forbearance. Assuming that the asset is classified as a loan and receivable and so is carried at amortised cost, its impairment is measured as the difference between:

- the carrying amount; and
- the net present value of the estimated future cash flows, inclusive of incurred credit losses, discounted using the asset's original effective interest rate (EIR).

The estimated cash flows to be taken into account when measuring impairment will depend on whether the original asset is to be derecognised, as follows.

	Original asset derecognised	Original asset not derecognised
What are the estimated cash flows to be taken into account?	The expected fair value of the new asset is treated as a final cash flow from the existing financial asset at the time of derecognition. This amount is discounted from the expected date of derecognition to the reporting date at the original EIR of the existing asset. Any difference at the time of derecognition between the actual fair value of the new asset and the previous estimate would give rise to an additional impairment or reversal of impairment.	The estimated cash flows will comprise the new contractually modified cash flows based on their expected timing. If the bank does not expect to receive the new modified contractual cash flows in full, then it adjusts the cash flows to reflect its estimates of receipts.

If the original asset subject to modification is derecognised, then the new modified asset is recognised at its then fair value. When restructuring results from financial difficulties of the borrower, an additional consideration is whether the new asset is impaired at initial recognition. This is relevant to estimating the EIR of the new asset at initial recognition.

Under IAS 39, the EIR is calculated by taking into account all future cash flows from an instrument that are expected to arise under the contract but excluding future credit losses. However, if an asset is impaired at initial recognition, then the EIR for the asset is estimated inclusive of the incurred credit losses. Accordingly, assessing whether a modified asset is impaired at initial recognition is an important factor in determining its EIR and therefore the future pattern of interest and any impairment recognition.

Collective impairment and appropriate disaggregation

If an asset subject to forbearance is assessed for impairment on a portfolio basis, then the bank will have to consider whether the asset should be moved to a different pool to meet the IAS 39 requirement, for purposes of the collective assessment of impairment, that assets be grouped on the basis of similar credit risk characteristics.

Assets subject to forbearance are unlikely to share similar credit risk characteristics with loans that have never been modified. It may be difficult to argue that loans considered to be 'cured' because they have returned to a performing status have similar credit characteristics to those of the rest of the good book unless a significant amount of time has elapsed post-modification and during that period the loan has demonstrated payment performance in line with the new contractual terms. Loans subject to forbearance would most likely be subject to separate management, which in turn would suggest different inputs and assumptions in impairment loss calculations regarding roll rates, delinquency rates, loss rates etc.

Concerns have been raised by stakeholders that the inappropriate pooling of loans subject to forbearance arrangements with other performing loans may result in understatement of the impairment allowance. Banks should ensure that modified loans are not grouped together with unmodified ones, if doing so would mean that loans that do not share similar credit characteristics would be grouped together.

Enhanced disclosures

Currently effective IFRSs do not contain specific disclosure requirements relating to forbearance activities. However, disclosures have to be made in response to the general requirements of IFRS 7 and IAS 1 *Presentation of Financial Statements.* IAS 1 requires the disclosure of the assumptions that an entity makes about the future and other sources of estimation uncertainty that have a significant risk of a material adjustment to the carrying amounts of assets and liabilities. IFRS 7 requires the disclosure of information that enables the users of a bank's financial statements to evaluate the significance of financial instruments for its financial position and performance as well as the risks associated with these financial instruments.

Regulators are pressing for more granular disclosures in this area so that users of financial statements have sufficient information to assess the extent of a bank's forbearance activities on its credit risk exposures, and to ensure that the credit risk arising from assets subject to forbearance is not obscured by their newly gained improved overdue status.

The ESMA report recommends that financial institutions include qualitative and quantitative disclosures about the nature and extent of forbearance practices in their IFRS financial statements. Qualitative disclosures may include details of the practices, related risks and how they are managed and applicable accounting policies.

Quantitative disclosures may include:

- carrying amounts of assets subject to forbearance (analysed, for example, by type of forbearance measure or business or geographical area, as appropriate);
- forbearance activity during the period, including a reconciliation of opening and closing balances;
- related impairment allowances;
- newly recognised assets;
- interest income; and
- analysis of credit quality.

The EDTF report notes that users have expressed a particular concern about disclosures of the nature and extent of a bank's loan forbearance and modification practices, and how they may affect the reported level of impaired or non-performing loans.

Other regulators, including the FSA and the AMF, have provided their own guidance in this area. It is clear that there are many voices calling for more transparency of disclosures and more information in this area.

IFRS 9: Expected credit losses

In March, the IASB published ED/2013/3 *Financial Instruments: Expected Credit Losses* (the ED), which would replace the existing 'incurred loss' model with an 'expected loss' approach. Under the model, financial assets would carry a loss allowance equal to:

- 12-month expected credit losses; or
- lifetime expected credit loss if, at the end of the reporting period, the credit risk of the financial asset has increased significantly since initial recognition.

The new proposals contain explicit guidance on the recognition of gains or losses on modification, and the impairment of modified financial assets. The population of modified assets is wider than assets subject to forbearance because assets may also be modified for other reasons, not related to financial difficulties of the borrower. However, similar to IAS 39, the proposals do not contain guidance on when a modified asset should be derecognised. The table below summarises the ED's proposals on modified assets.

Type of modification	Recognition of gain or loss on modification	Recognition of impairment
Resulting in derecognition of the original assets	Gain or loss recognised in P&L, being the difference between: • the carrying amount; and • the fair value of the newly recognised modified financial asset.	The new asset is assessed for impairment as any other new asset, unless the new asset is considered to be credit-impaired at initial recognition.
Resulting in continuing recognition of the modified asset	Gain or loss recognised in P&L, being the difference between: • the carrying amount; and • the net present value of the modified cash flows discounted at the asset's original (pre-modification) EIR.	To assess whether the credit risk of the modified asset has increased significantly, comparison is made between: • the probability of default at the measurement date; and • the probability of default at initial recognition of the original (pre-modified) asset.

The ED proposes extensive disclosures in respect of modified financial assets.

For details of KPMG's publication on the proposed impairment model to form part of IFRS 9 – *New on the Horizon: Financial Instruments: Expected Credit Losses* – see page 18.

REGULATION IN ACTION: BASEL III AND LIMITED AMENDMENTS TO IFRS 9

Understanding the interactions

Basel III – more changes on the way

The Basel III framework was agreed in 2010 by the Basel Committee on Banking Supervision (BCBS) to promote a more resilient global banking system. Its components include:

- raising the quality, consistency and transparency of capital;
- strengthening counterparty risk capital requirements;
- introducing a leverage ratio;
- introducing a global minimum liquidity standard; and
- promoting capital buffers.

A significant change introduced by Basel III is the new liquidity framework, including a new short-term liquidity coverage ratio (LCR).

The implementation timeline for the overall Basel III framework incorporates a number of milestones from 2013 to 2019. Despite implementation delays in certain jurisdictions (e.g. in the EU and the US), as at January 2013, 11 out of 19 BCBS member states had Basel III rules in place. Stefan Ingves, chairman of the BCBS, believes that "by the end of 2013, almost all Basel Committee jurisdictions will be implementing Basel III in accordance with the agreed timetable". As banks address the implementation challenges of Basel III, they will need to bear in mind the impact of, and interaction with, accounting requirements.

Accounting rules are changing, too

Measuring assets at amortised cost generally leads to less volatility in P&L, other comprehensive income (OCI) and equity than measuring assets at fair value. Under the proposed amendments to the classification and measurement chapters of IFRS 9 – exposure draft ED/2012/4 *Classification and Measurement: Limited Amendments to IFRS* (the classification and measurement ED) – although P&L volatility from some assets may be reduced, other assets previously expected to be measured at amortised cost may need to be measured at FVOCI.

Under the current requirements of IFRS 9, financial assets that are debt instruments are measured either at amortised cost or at FVTPL. Equity investments are measured either at FVTPL or in certain circumstances at FVOCI. Debt instruments are measured at amortised cost if they are held within a business model whose objective is to hold the assets to collect contractual cash flows and the contractual terms of the assets give rise to cash flows that are solely payments of principal and interest (the SPPI criterion).

The proposed amendments to IFRS 9 introduce a new FVOCI measurement category and a new business model for financial assets that are debt instruments. The new model would be for assets that are managed both to collect contractual cash flows and for sale. Assets held within the new business model that meet the SPPI criterion would be measured at FVOCI. In assessing the business model within which an asset is held, a bank would need to consider the level of sales activity, as well as the reason for any sales. The classification and measurement ED includes new application guidance to help determine how the frequency and significance of actual and expected asset sales affect the business model assessment.

The classification and measurement ED also introduces a new 'modified economic relationship' test to add to the existing assessment of whether a financial asset meets the SPPI criterion. The test would require more judgement for determining both:

- what is a 'benchmark' instrument; and
- when cash flows in a modified relationship are 'more than insignificantly different' from a benchmark instrument.

If cash flows are more than insignificantly different from benchmark cash flows, then the financial asset would not satisfy the SPPI criterion and so would have to be measured at FVTPL.

What is the impact?

The main regulatory impact for banks stemming from the proposed changes to IFRS 9 is a potential increase in volatility of:

- regulatory capital resources;
- risk-weighted assets; and
- LCR.

This could be the case for banks already reporting under IFRS 9 as well as for those that will implement it later. Below, we look at some of the accounting issues in more detail.

Regulatory capital – Impact of the proposed FVOCI category and the modified economic relationship test

The Basel III framework introduces a stricter definition of capital. Under Basel II, individual jurisdictions were able to decide to what extent they wanted to incorporate accumulated balances in OCI into banks' regulatory capital. Under Basel III, Common Equity Tier 1 would always include the full amount of changes in the fair values of financial assets recognised in OCI.[3] With a global move to Basel III, the proposed changes to IFRS 9 may require careful analysis of the potential impact on banks' regulatory ratios.

The impact on regulatory capital would depend on how financial assets are classified and measured under the current and the proposed requirements. For example, if assets classified as at FVTPL under the existing IFRS 9 move to the FVOCI category, then there would be no impact on regulatory capital because all fluctuations in fair value movement would already have been included in the regulatory capital. However, if assets that the bank previously considered to meet the criteria for amortised cost measurement are classified as at FVOCI under the amendment, then volatility of regulatory capital will result. Similarly, the application of the 'modified economic relationship' test may lead to FVTPL rather than amortised cost classification, although this result would probably be rare.

The diagram below summarises at a high level the potential impact on regulatory capital of the proposed amendments to IFRS 9 for a bank applying the current requirements of IFRS 9, assuming that its calculation of the regulatory capital includes fair value gains and losses recognised in OCI that are attributable to financial assets.

Classification under proposed amendments to IFRS 9 / Classification under current IFRS 9	Amortised cost	FVTPL	FVOCI
Amortised cost	No impact	Higher regulatory capital volatility	Higher regulatory capital volatility
FVTPL	Lower regulatory capital volatility	No impact	No impact

Additional complexities in the analysis may arise when banks currently applying IAS 39 transition directly to the amended IFRS 9. Debt instruments classified as available-for-sale (AFS) under IAS 39 are measured at fair value with gains and losses recognised in OCI. However, the AFS classification is not determined based on the business model and the SPPI test, but is a residual category. Therefore, assets measured at FVOCI under IAS 39 may not be eligible for the same measurement basis under the proposed amendments to IFRS 9.

3 Basel III rules allow phasing of the inclusion of fair value gains and losses on financial assets that are recognised in OCI with the full amount to be included in the calculation of regulatory capital on 1 January 2018.

The diagram below summarises at a high level the potential impact on regulatory capital for a bank transitioning from IAS 39 directly to the amended IFRS 9, assuming that its calculation of the regulatory capital includes fair value gains and losses recognised in OCI that are attributable to financial assets.

Classification under proposed amendments to IFRS 9 / Classification under IAS 39	Amortised cost	FVTPL	FVOCI
Amortised cost	No impact	Higher regulatory capital volatility	Higher regulatory capital volatility
FVTPL	Lower regulatory capital volatility	No impact	No impact
AFS	Lower regulatory capital volatility	No impact	No impact

The analysis would be more complex for banks transitioning to the amended IFRS 9 at the same time as moving from Basel II to Basel III, because multiple layers of changes would have to be considered.

Regulatory capital – Other potential impact of FVOCI classification

The introduction of the FVOCI category may also impact the regulatory capital ratio of a bank by affecting the measurement of risk-weighted assets, which are based on the amounts in the financial statements.

The impact of the frequency of sales on LCR

As mentioned above, Basel III will introduce a new liquidity ratio, LCR. The ratio is defined as:

$$\text{LCR} = \frac{\text{High-quality liquid assets}}{\text{Total net liquidity outflows over 30-day time period}} \geq 100\%$$

For the purposes of the ratio, high-quality liquid assets will be measured based on the amounts in the financial statements. Accordingly, any changes to the measurement basis under IFRS will have a direct impact on LCR and in some adverse scenarios could cause the ratio to fall below the level required by the regulator.

Under the proposed amendments to IFRS 9, debt instruments held in the liquidity portfolio that meet the SPPI criterion could be classified as measured at amortised cost, at FVTPL or at FVOCI, depending on the bank's assessment of the business model within which they are held. Some of the principal factors in determining the business model would be the frequency, timing and volume of sales in prior periods, reasons for such sales and expectations about sales activity in the future.

Highly liquid assets that are part of the LCR are intended to be used for funding unexpected cash outflows arising under a significantly severe liquidity stress scenario. Generally, regulators require banks to demonstrate liquidity in these portfolios by periodic sales of assets. The levels of required regulatory sales may vary from jurisdiction to jurisdiction. Judgement will need to be exercised to determine the impact of the regulatory sales on a bank's ability to conclude that such assets are held in a 'held-to-collect' business model and so are eligible for measurement at amortised cost.

If amortised cost classification is not appropriate then, under the classification and measurement ED, assets in the portfolio would be measured at fair value (either at FVOCI or at FVTPL), leading to volatility in LCR. Although the classification and measurement ED provides a description of the objective of the business model assessment and application guidance and examples, in many cases determining the appropriate business model will still involve a high degree of judgement.

The consultation period for the classification and measurement ED ended on 28 March 2013. Currently, the effective date for IFRS 9, including the proposed amendments, is annual reporting periods beginning on or after 1 January 2015. However, in view of the current status of the remaining parts of IFRS 9, such as impairment, the effective date is likely to be further delayed.

Potential implementation challenges

The interaction between changes to the regulatory and accounting requirements in this area means that the two projects would require co-ordination. In some areas, the two project teams would have to work closely together to ensure that the interactions between the two sets of requirements are appropriately assessed.

The European Commission publishes proposals for a financial transaction tax

In February, the European Commission published its proposals for a financial transaction tax (FTT).

The proposals would introduce a tax on transactions in certain financial instruments undertaken by financial institutions such as banks, investment firms, pension funds, insurance entities, UCITS[4] and alternative investment funds. The FTT would apply to financial institutions in the FTT zone[5]. It would also apply to institutions outside the FTT zone if they transact with counterparties in the FTT zone or in trade securities issued in the FTT zone. Generally, the FTT would be applied at the rate of 0.01 percent of the nominal value of derivatives and 0.1 percent of the market value of securities. However, the actual amount of tax payable could be much higher if several intermediaries are involved – e.g. a broker or CCP. The proposed effective date is 1 January 2014.

The proposals may have accounting implications. The multiple layers of taxation (i.e. tax being levied each time a security is sold) may adversely impact trading volumes and therefore liquidity and the bid-offer spread. This in turn could affect banks' assessment of their principal or most advantageous market for the purpose of arriving at the fair value of a financial instrument under IFRS 13 *Fair Value Measurement*.

Also, the FTT is likely to meet the definition of a transaction cost under IAS 39 and IFRS 9. Accordingly, it would be part of the EIR on debt instruments classified as held-to-maturity, loans and receivables or AFS.

EU OTC derivative rules get final clearance

The *European Market Infrastructure Regulation* (the Regulation) requires, inter alia, that entities entering into OTC derivative contracts subject to a mandatory clearing obligation clear the derivatives through a CCP. Most of the Regulation's provisions apply only after technical standards come into force. The technical standards were published in the *Official Journal of the European Union* in February 2013 and came into force on 15 March. There will be a phase-in period for the requirements of the Regulation but it is expected that the majority of its provisions will be effective during 2013.

As discussed in the January 2012 issue of *The Bank Statement*, the key accounting implication of the Regulation relates to banks' ability to continue with hedge accounting if a derivative that is part of a hedge relationship is novated to a CCP; for details of proposed amendments to IAS 39 and IFRS 9 on the novation of derivatives and continuation of hedge accounting, see page 3.

Our January 2012 issue also noted the following additional accounting considerations arising from clearing derivatives through CCPs:

- changes to the fair value of derivative contracts, due to the potential impact of any changes in collateralisation requirements and counterparty credit valuation adjustments (CVA);
- offsetting analysis under IAS 32 (due to the change of a counterparty to a CCP); and
- principal vs agent analysis and the effect on client money accounting.

In addition, banks may need to consider the implication for IFRS 7 offsetting disclosure requirements for their interim condensed financial statements; for details of Interpretations Committee discussions in March about offsetting disclosure requirements in interim financial statements, see page 6.

4 UCITS: Undertakings for collective investment in transferable securities in the European regulatory framework
5 The FTT zone comprises Austria, Belgium, Estonia, France, Germany, Greece, Italy, Portugal, Slovakia, Slovenia and Spain.

EFRAG voices concerns about proposed transition from IAS 39 to IFRS 9 for macro hedging practices

In March, the European Financial Reporting Advisory Group (EFRAG) published a comment letter to the IASB in which it expressed its views on the impact of the transition from IAS 39 to the IFRS 9 hedge accounting model while the macro hedging project is developing. The letter follows the field test that EFRAG conducted together with the national standard setters *Autorité des Normes Comptables* (ANC; France), the Accounting Standards Committee of Germany (ASCG), the Financial Reporting Council (FRC; the UK) and the *Organismo Italiano di Contabilita* (OIC; Italy).

EFRAG believes that to avoid the cost and disruption of successive changes in hedge accounting requirements, entities should be permitted to maintain in all circumstances the current IAS 39-compliant portfolio hedge accounting practices until the project on macro hedging is completed.

BCBS publishes principles for effective risk data aggregation and risk reporting

Following the growing concerns of national regulators over major banks' ability to aggregate their risk exposures in a timely manner (both for internal reporting purposes and for meeting information requests from supervisors), in January the BCBS published *Principles for effective risk data aggregation and risk reporting*. The principles relate to the:

- aggregation of risk data;
- production of risk management reports;
- importance of IT capabilities in these areas; and
- need for strong governance arrangements around data aggregation and reporting.

One of the principles requires banks to perform a reconciliation between risk data compiled for regulatory purposes and accounting data. Because the two sets of information are likely to be prepared by different departments within a bank, they could potentially be compiled using different assumptions and be sourced from different systems. Accordingly, preparing the required reconciliation may not be a simple task and may need system and processes changes.

G-SIB[6]s are expected to comply with these principles by 2016 (with self-assessments beginning this year), whereas D-SIB[7]s may have up to three years from the date of being designated as such. National regulators may apply the principles to other banks on a proportionate basis.

6 G-SIB: global systematically important bank
7 D-SIB: domestic systematically important bank

YOU ALSO MAY BE INTERESTED TO READ ...

New on the Horizon: Financial instruments – Expected credit losses

Considers the new impairment model proposed by the IASB in ED/2013/3 *Financial Instruments: Expected Credit Losses* and provides KPMG's insight.

March 2013

IFRS – Financial Instruments Newsletter: The future of IFRS financial instruments accounting, Issues 9 and 10

Highlights the recent discussions and tentative decisions of the IASB on the financial instruments project.

January 2013 and February 2013

IFRS – Insurance Newsletter: Moving towards global insurance accounting, Issues 33, 34 and 35

Summarises the recent discussions of the Boards on the joint insurance contracts project and gives the current status of the project.

January 2013, February 2013 and March 2013

IFRS – Revenue Newsletter, Issues 6, 7 and 8

Outlines the current thinking on the revenue project, and what the proposals could mean for entities.

January 2013, February 2013 and March 2013

In the Headlines: Continuing hedge accounting after derivative novations, Issue 2013/02

Focuses on proposed amendments to IAS 39 and IFRS 9 *Novation of Derivatives and Continuation of Hedge Accounting* to require an existing hedging relationship to continue if a novation meets specific criteria.

March 2013

In the Headlines: Reminder: Effective dates of IFRS, Issue 2013/03

A reminder of newly effective standards and standards issued but not yet effective for annual reporting periods ending on or after 31 March 2013, and interim periods within these annual reporting periods.

March 2013

Click on the images above to access the publications

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