THE BANK STATEMENT

Q2 2013 NEWSLETTER

KPMG

cutting through complexity

"With only months to go before issuing their first annual reports under IFRS 13, banks will need to address implementation issues, particularly in areas where there is limited guidance or where industry practice is still developing."

Mahesh Narayanasami, Accounting Advisory Services, KPMG in Canada

IMPLEMENTATION OF IFRS 13 AND COMPARISON OF IASB IMPAIRMENT PROPOSALS WITH BASEL CALCULATIONS

Welcome to the Q2 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 provides welcome relief from the **discontinuation of hedge accounting** if the derivative hedging instrument is novated to a clearing counterparty, provided that certain criteria are met – see page 2.
- The IASB issues guidance on accounting for **liabilities for levies** in accordance with the provisions standard. Under this guidance, the recognition of levies in interim financial statements may result in uneven charges over the course of the year – see page 2.
- **IFRS 13 *Fair Value Measurement***, which is effective from 1 January 2013, provides a single source of guidance on fair value measurement and replaces the guidance that was previously dispersed throughout IFRS. We consider some of the implementation issues that banks may face – see page 6.
- Following the issue by the IASB of its exposure draft **ED/2013/3 *Financial Instruments: Expected Credit Losses***, many banks have been focusing on identifying crossovers and synergies between the proposals and the **regulatory capital calculations under Basel** – see page 12.

IASB ACTIVITIES AFFECTING YOUR BANK

IASB provides limited-scope relief for a widespread issue resulting from derivative novations

As discussed in previous editions of *The Bank Statement*, changes in laws and regulations on over-the-counter (OTC) derivatives in several jurisdictions lead to entities novating many OTC derivatives to a clearing counterparty. Many derivatives that are, or may be, subject to the novation have been designated in hedging relationships. Under IAS 39 *Financial Instruments: Recognition and Measurement*, novation of a derivative contract to a clearing counterparty would lead to discontinuing hedge accounting unless the hedging instrument is being replaced as part of the entity's original documented hedging strategy. The IASB believed that this was not a desirable outcome.

In June 2013, the IASB issued *Novation of Derivatives and Continuation of Hedge Accounting (Amendments to IAS 39)*, which introduce a limited exception to IAS 39 to provide relief from discontinuing an existing hedging relationship when a novation that was not contemplated in the original hedging documentation meets all of the following criteria:

- the novation is made as a consequence of laws or regulations or the introduction of laws or regulations;
- a clearing counterparty becomes a new counterparty to each of the original parties; and
- the changes to the terms of the derivative are limited to those necessary to replace the counterparty.

The IASB intends to include similar provisions in its forthcoming standard on general hedge accounting under IFRS 9 *Financial Instruments*.

For more details, see KPMG's publication on the amendments – *In the Headlines: Continuing hedge accounting after derivative novations* – on page 18.

IFRIC Interpretation provides clarity on accounting for levies

In May 2013, the IASB issued Interpretation 21 *Levies*, which addresses the key accounting question for those who pay a levy: when should you recognise a liability?

The interpretation at a glance

The interpretation provides guidance on accounting for levies in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. In summary, it:

- defines a levy as an outflow from an entity that is imposed by a government in accordance with legislation; however, outflows within the scope of IAS 12 *Income Taxes,* fines and penalties, and liabilities arising from emissions trading schemes are excluded from the scope;
- confirms that an entity recognises a liability for a levy when – and only when – the triggering event specified in the legislation occurs;
- clarifies that, if a levy is only payable once a specified minimum threshold has been reached, then no liability is recognised until the threshold is reached; and
- confirms that the same recognition principles apply in the interim financial statements as in the annual financial statements, even if this results in an uneven allocation of expenses throughout the year.

Example – Interim reporting

A bank with a 31 December year end is liable to pay a levy if it operates in a specific market on 31 December 2013, but is not liable if it ceases to operate before that date.

Under the interpretation, the bank does not recognise a liability for the levy – or any portion of the levy – in its interim financial statements for the six-month period ending on 30 June 2013.

The interpretation provides guidance only on the timing of recognition of a liability. Whether the associated debit side of the entry is an asset or an expense is determined by applying other relevant IFRSs.

Effective date and transition

The interpretation is effective for annual periods beginning 1 January 2014 and is to be applied retrospectively. Early application is permitted.

For more details, see KPMG's publication on the interpretation – *In the Headlines: Liabilities for levies* – on page 18.

Fair value measurement – Clarifications pending

The unit of account for investments in subsidiaries, joint ventures and associates

In its previous meetings, the IASB had tentatively decided that the unit of account for measuring the fair value of investments in subsidiaries, joint ventures and associates should be the investment as a whole; and that if the investment comprises quoted financial instruments, then fair value should be determined as the product of the quoted price of the instrument and the quantity held.

In May 2013, the IASB decided to revisit this topic after considering further issues that may arise as a consequence of the portfolio exception issue discussed below.

The interaction between the portfolio exception and Level 1 inputs in IFRS 13

In May 2013, the IFRS Interpretations Committee discussed the interaction between the use of Level 1 inputs and the portfolio exception in IFRS 13, which in certain circumstances allows entities to measure their net exposure to either market risks or credit risks arising from a group of financial assets and financial liabilities. The question put to the Committee was whether for a portfolio consisting solely of identical Level 1 instruments:

- it is permissible to measure fair value on the basis of net risk; or
- the fair value is required to be measured by using Level 1 prices for each financial instrument.

The Committee observed that there is insufficient guidance in IFRS 13 and that the issue needs to be considered by the IASB.

IASB's surprising decision on general hedging

In April 2013, the IASB took a surprising decision to give entities an accounting policy choice to either:

- adopt the new general hedging model of IFRS 9; or
- continue to apply the hedge accounting model in IAS 39 until the standard resulting from the IASB's separate macro hedging project is effective.

The decision followed the recommendation made by the European Financial Reporting Advisory Group (EFRAG) to the IASB, in which it voiced concerns about the proposed transition from IAS 39 to IFRS 9 for certain macro hedging relationships; for further discussion, see *The Bank Statement* Q1 2013.

Notwithstanding its decision to make the general hedge accounting model in IFRS 9 optional, the IASB decided that the new disclosures about risk management and hedging activities that are being added to IFRS 7 *Financial Instruments: Disclosures* will be mandatory irrespective of the accounting policy choice made.

The IASB concluded that the due process on general hedging has been completed and that re-exposure of the proposals would not be necessary. The IASB expects to publish the final standard in Q3 2013.

Boards decide not to provide specific guidance for credit card reward programmes

In May 2013, the IASB and the FASB (the Boards) considered a request for clarification on how the revenue model proposed in ED/2011/6 *Revenue from Contracts with Customers* (the revenue ED) would apply to credit card reward programmes.

The revenue ED included an illustrative example on accounting for customer loyalty programmes – Example 24 – in which the entity concludes that the reward points are a separate performance obligation and so it defers revenue when accounting for sales in which reward points are granted. Respondents to the revenue ED from the financial services industry asked whether Example 24 was intended to be applied to reward programmes offered by credit card issuers, because this would potentially preclude a cost-deferral approach to accounting for such programmes. This is because the reward points under such programmes would be treated as an unfulfilled separate performance obligation.

The Boards decided not to provide specific guidance on applying the revenue model to credit card reward programmes. Instead, they decided to amend Example 24 to clarify that it does not necessarily apply to all customer loyalty programmes and that an entity should consider all facts and circumstances to determine whether the promise to transfer the award credits gives rise to a performance obligation.

For further discussion of developments in the application of the revenue recognition model to credit card reward programmes, see KPMG's publication *IFRS Newsletter: Revenue: Transaction declined – No new guidance for credit card issuers* – on page 18. This issue is also discussed in *The Bank Statement* Q1 2012.

The applicability of IFRS 7 offsetting disclosure requirements to condensed interim financial statements is clarified

In April 2013, the IASB discussed the applicability to condensed interim financial statements of the new offsetting disclosures required by the amendments to IFRS 7. It agreed that these disclosures are not specifically required for all interim periods after the first year of application. By focusing on whether the disclosures were required for interim periods after the year of initial application, the IASB did not contradict the IFRS Interpretation Committee's initial conclusion that it was unclear whether the disclosures were specifically required in the year of initial application. As a result, it is up to entities to evaluate what disclosures would be appropriate under the general principles of IAS 34 *Interim Financial Reporting*. The additional disclosures are required to be given in condensed interim financial statements that are prepared in accordance with IAS 34 if their inclusion is required by the provisions of IAS 34. IAS 34 requires the disclosure of information in condensed interim financial statements if its omission would make them misleading.

IASB clarifies that servicing arrangements are within the scope of disclosures on transfers of financial assets

In October 2010, the IASB issued *Disclosures – Transfers of Financial Assets (Amendments to IFRS 7)*. The amendments require the disclosure of information on transferred financial assets, including assets that have been derecognised but in which an entity retains continuing involvement.

Key to the scope of disclosures for transferred assets that have been derecognised is the definition of 'continuing involvement' in the *Amendments to IFRS 7*. In January 2013, the IFRS Interpretations Committee recommended that the IASB consider clarifying the definition because it is currently unclear whether servicing arrangements are deemed to constitute continuing involvement for the purpose of applying the transfer disclosure requirements. The IASB discussed this subject in February and noted that its intention was that servicing arrangements would meet the definition of continuing involvement in the *Amendments to IFRS 7*.

In light of the IASB's discussions, in May the Committee recommended that the IASB propose an amendment to IFRS 7 to clarify that the requirements in IFRS 7 on disclosures on transfers of financial assets do not exclude servicing agreements. It may be possible to achieve this clarification through the annual improvements process.

IFRS Interpretations Committee considers the effect of protective rights on the assessment of control

In May 2013, the IFRS Interpretations Committee continued discussing the impact of a change in facts and circumstances on rights previously determined to be protective. For example, on the breach of a covenant in a borrowing arrangement that leads to the borrower's default, such rights may become exercisable. The question submitted to the Committee was whether on a change of circumstances the control assessment under IFRS 10 *Consolidated Financial Statements* should:

- be reassessed; or
- remain unaffected – i.e. such rights are never included in the reassessment of control.

The Committee observed that IFRS 10 requires an investor to reassess all rights to establish whether it controls an investee when facts and circumstances change. Accordingly, if the breach of a covenant results in the rights becoming exercisable, then the reassessment of control is required. The Committee noted that IFRS 10 does not include any exemption for any rights from the reassessment requirement. The Committee tentatively decided not to add this issue to its agenda because it did not expect significant diversity in practice, and will finalise its discussions in September.

Insurance and leases projects

In May 2013, the Boards issued a revised exposure draft ED/2013/6 *Leases*. The new proposals would fundamentally change lease accounting and would bring most leases onto lessees' balance sheets.

In June 2013, the IASB issued exposure draft ED/2013/7 *Insurance Contracts*, marking a major step forward towards implementing a common insurance reporting framework across much of the world. The debate has run for more than 15 years and the conclusion of the insurance project is now in sight.

KPMG has recently released publications on both EDs – see page 18.

IFRS 13 CONSIDERATIONS FOR FINANCIAL INSTRUMENTS

> "The magnitude of the challenge of implementing IFRS 13 will depend on a bank's existing approach under IAS 39/ IFRS 9 and the nature of its business and the financial instruments held."

Editorial by Mahesh Narayanasami, KPMG in Canada, discussing some of the impacts of IFRS 13

IFRS 13 *Fair Value Measurement*, which is effective from 1 January 2013, provides a single source of guidance on how fair value is measured and replaces fair value measurement guidance that was previously dispersed throughout IFRS. The standard amends the definition of fair value, establishes a framework for measuring fair value and sets out related disclosure requirements.

Although the principal objectives of IFRS 13 relating to financial instruments are similar to those in IAS 39, some of the key definitions, such as the definition of fair value, have changed and result in differences – perhaps subtle – that may significantly impact application in practice. IFRS 13 expands and articulates in more detail the concepts and principles behind fair value, including the introduction of new concepts such as the 'principal market'. It also includes general descriptions of valuation approaches and techniques.

With only months to go before issuing their first annual reports under IFRS 13, banks will need to address implementation issues, particularly in areas where there is limited guidance or where industry practice is still developing.

This article considers some of the implementation issues relating to IFRS 13.

Can the valuation of financial instruments be performed on a portfolio basis?

Although fair value is generally determined on an instrument-by-instrument basis, under both IAS 39 and IFRS 9, a portfolio valuation may be appropriate as a practical expedient to determine the sum of the fair values of the individual instruments within a portfolio. Also, entities that have assets and liabilities with offsetting market risks may use mid-market prices as a basis of establishing fair value for the offsetting risk positions and apply the bid or asking price to the net open position.

IFRS 13 generally does not specify the level of aggregation or disaggregation of assets and liabilities for the purpose of determining at what level fair value should be measured. The unit of account is usually determined under the IFRS that requires or permits the fair value measurement. The unit of account in IAS 39 or IFRS 9 is generally an individual financial instrument. However, IFRS 13 includes an optional exception for the measurement of a group of financial assets and liabilities that is exposed to market risks or to the credit risk of each of the counterparties, if certain criteria are met. The exception allows a bank to measure the fair value of a group of financial assets and financial liabilities on the basis of the price that would be received to sell a net asset position or transfer a net liability position for the particular risk exposure that is managed on a group basis.

Banks will have to consider whether adopting IFRS 13 impacts their existing approach to arriving at fair values.

Is the portfolio approach appropriate for Level 1 financial instruments?

An issue that may be relevant to banks intending to use the portfolio measurement exception under IFRS 13 is its interaction with guidance in the standard on Level 1 inputs. Generally, under IFRS 13, Level 1 prices should not be adjusted when determining fair values. However, there is insufficient guidance in IFRS 13 to determine whether an entity is:

- permitted to apply the portfolio exception in IFRS 13 to measure the net risk exposure of a portfolio consisting solely of Level 1 instruments; or
- required to measure the financial assets and financial liabilities forming the portfolio on an individual basis, using the corresponding Level 1 prices for each financial instrument.

Example – Interaction between Level 1 prices and the portfolio measurement

Bank B has a portfolio of identical Level 1 instruments comprising a long position of 5,000 individual financial assets and a short position of 4,500 individual financial liabilities. The portfolio meets the criteria for the exception in IFRS 13 permitting measurement of fair value on the basis of the net position. The most representative exit price within the bid-ask spread[1] for an individual financial asset is 49, and for an individual financial liability is 51.

If entities are not permitted to apply the portfolio measurement exception to positions comprising identical Level 1 instruments, then the fair value measurements would be based on the individual Level 1 fair values of each individual financial asset and financial liability. This would amount to 15,500 = (5,000 x 49 - 4,500 x 51).

If entities are permitted to apply the portfolio measurement exception to such a position, then a further question arises – whether entities would:

- measure such a net risk exposure by applying Level 1 prices to each individual instrument that comprises the net risk exposure (i.e. 24,500 = 500 x 49); or
- view the net risk exposure as a whole and, consequently, consider adjusting 24,500 for relevant premiums and discounts.

The lack of clarity over the application of the portfolio measurement exception to Level 1 financial instruments was discussed by the IFRS Interpretations Committee in its May 2013 meeting. The Committee acknowledged that there was insufficient guidance in IFRS 13 for it to be able to answer the question, and referred the issue to the IASB for consideration. It is expected that the IASB will discuss it in a forthcoming meeting. For details of the Committee's discussions on the subject, see page 3.

Does implementation of IFRS 13 impact valuation adjustments to reflect credit risk?

IAS 39 and IFRS 9 state that the fair value of a financial instrument reflects its credit quality. However, because there is no explicit guidance on incorporating credit risk into the valuation of financial instruments, diversity in practice has arisen. Discussions of credit risk adjustments often focus on the following:

- issued liabilities
- derivative assets
- derivative liabilities.

Although there has generally been a consensus that the valuation of derivative assets under IAS 39 and IFRS 9 should incorporate credit valuation adjustments (CVA), in our experience practice has differed in relation to incorporating debit valuation adjustments (DVA) in the valuation of derivative liabilities and own credit risk in the valuation of liabilities issued.

IFRS 13 specifically states that the fair value of a liability reflects the effect of non-performance risk, which is the risk that an entity will not fulfil an obligation. Non-performance risk is assumed to be the same before and after the transfer of the liability and includes an entity's own credit risk. The requirement in IFRS 13 to include own credit risk is also consistent with the requirement to value a financial liability from the perspective of an entity that holds this item as an asset, and should lead to greater consistency in practice between the calculation of DVA and CVA in measuring derivative assets and liabilities.

1 IFRS 13 requires that if an asset or a liability has a bid and an ask price, then the entity uses the price within the bid-ask spread that is most representative of fair value in the circumstances.

Therefore, adopting IFRS 13 may affect the calculation of fair values if the bank did not previously consider DVA in measuring its derivative liabilities or non-performance risk in the valuation of its liabilities issued. We consider below some accounting issues relating to inclusion of DVA in fair value measurement.

What issues may arise in practice on the incorporation of credit risk into fair value measurement on a portfolio basis?

IAS 39 allows the fair value measurement of financial instruments with offsetting market risks through measuring the offsetting risk positions at mid-market prices and applying bid or ask adjustments to the net open position. Although IAS 39 / IFRS 9 do not contain specific guidance on the measurement of the fair value of financial instruments with offsetting credit risk, market practice has developed and many entities apply similar approaches. This is because credit risk is generally assessed and monitored at the counterparty level rather than the individual instrument level.

IFRS 13 provides specific guidance on the calculation of adjustments for credit risk (which would include both CVA and DVA). It requires an entity, when it applies the portfolio approach to measuring fair value (i.e. it measures the fair value of a group of financial assets and financial liabilities entered into with a particular counterparty), to include the effect of its net exposure to the credit risk of that counterparty in the fair value measurement if a market participant would take into account the arrangement to mitigate credit risk (such as master netting agreements or collateral) on the basis of the net exposure to the counterparty. Banks will need to assess whether their existing methodology for calculating adjustments to incorporate credit risk complies with the requirements of IFRS 13 – e.g. whether the portfolio exception criteria in IFRS 13 are met.

However, the IFRS 13 exception for portfolio measurement is not carried through to the presentation of the related financial assets and financial liabilities in the financial statements. Accordingly, if a bank applies the exception, then the basis of measurement of a group of financial instruments may differ from the basis of presentation. If financial instruments that are part of a portfolio are presented separately on a gross basis in the statement of financial position, but their fair value is measured on a net exposure basis, then the portfolio-level credit adjustments would have to be allocated to the individual financial assets and financial liabilities on a reasonable and consistent basis.

What are the difficulties arising from the interaction of DVA with FVA?

One of the inputs into the valuation of derivatives is the discount rate applied to future cash flows. In general, there has been a move towards using the overnight index swap (OIS) rate to discount cash flows from collateralised derivatives. However, in our experience, practice varies over the rates used to discount the cash flows of uncollateralised derivatives and there is debate on whether and how the bank's own funding costs should be incorporated into the valuation of derivatives.

Although derivative valuation theory recognises conceptual differences between the collateralised and uncollateralised transactions, the very small basis spreads that existed pre-financial crisis between the interest rate curves used for discounting collateralised and uncollateralised trades meant that the impact on valuations was rarely significant. With the financial crisis and economic downturn causing widening spreads, the issue has gained importance.

While academics debate whether funding costs should be included as part of fair value measurements, many banks share the view that the exit price of an uncollateralised derivative reflects the impact of these funding costs. However, what is still the subject of industry discussions and debate is the basis on which these costs should be determined.

Some are of a view that estimated cash flows should be discounted using a bank's own cost of funding. Indeed, a typical market participant would generally consider its funding costs in setting the price of a new derivative transaction. Banks would need to ensure that any funding cost risk

adjustment used in measuring fair value is consistent with the cost that market participants would take into account when pricing an instrument.

A contentious issue that is being debated is the potential overlap in a valuation model between the funding valuation adjustment (FVA) and DVA. A bank's own cost of funding typically incorporates both liquidity and credit components. A DVA adjustment reflects non-performance risk, incorporating credit considerations. A double count could arise if all of the uncollateralised cash flows of a derivative were discounted using an all-in funding rate and a separate DVA adjustment was also applied. Our experience shows that the elimination of a potential double counting of own credit risk in such situations proves to be a difficult task for banks. This is primarily because of the inherent difficulty of trying to isolate from a single funding rate the element that relates to own credit and the element that reflects market or bank-specific liquidity concerns. Indeed, some believe that the two are inextricably linked.

Some banks believe that double counting of the own credit effect could be eliminated by using own CDS-bond spread (i.e. the basis between a bank's bonds and CDS spreads) as a proxy for the element of funding costs that relates to liquidity (because it represents a basis between a funded credit instrument and an unfunded one). Others argue that the exit price should be determined by adding a fixed FVA spread to the DVA. As the debate continues on how to determine funding rates, many tend to believe that any method would contain a degree of inaccuracy. Nevertheless, it is becoming increasingly apparent that the FVA is here to stay and that market practice will evolve over time. It is also becoming apparent that with valuation models becoming more and more complex, the biggest question left to be answered is: where to draw the line? For example, should the next step be incorporation of the regulatory capital cost into the valuation model? If the instrument being sold, for instance, is capital-intensive and a trading desk is charged internally for entering into the new business, then it seems logical for the desk to charge the customer a spread to reflect that cost. If discount rates are not adjusted for this 'regulatory spread' that is reflected in the actual transaction, then the valuation of a derivative, assuming that it is based on observable inputs, would be different from its transaction price.

However, whatever discount rate is used in valuation, banks have to ensure that their application of IFRS 13 results in a value that would be paid to transfer a liability in the principal or most advantageous market, which means that the discount rate should reflect only inputs that market participants would consider.

For more discussion on funding costs in a bank's derivative business, see KPMG's publication – *FVA – Putting Funding into the Equation* – on page 18.

Does inclusion of DVA into fair value measurement impact hedging relationships?

The inclusion of DVA in the valuation of derivative instruments may affect effectiveness testing and ineffectiveness measurement. This is because there is unlikely to be an offsetting effect on the measurement of the changes in the value of the hedged item that is attributable to the hedged risk. Therefore, if the assessment of effectiveness applies a method that uses the hedging instrument's fair value change, then the inclusion of DVA may lead to the conclusion that the hedging relationship has not been and/or is not expected to be highly effective.

In addition, even when it is concluded that a hedge has been highly effective, measurement differences will result in ineffectiveness being recognised in profit or loss for fair value hedges. Such differences would also lead to the recognition of ineffectiveness in profit or loss for cash flow hedges if the cumulative gain or loss on the hedging instrument is greater (in absolute terms) than the cumulative change in fair or present value of the expected future cash flows on the hedged item. Similarly, for net investment hedges in which the hedging instrument is a derivative, ineffectiveness will be recognised in profit or loss if the gain or loss on the hedging instrument exceeds the foreign exchange differences arising on the designated net investment.

On transition to IFRS 13, banks may need to assess the impact on hedge accounting of the inclusion of DVA in the fair value of hedging derivatives in existing hedging relationships.

Does inclusion of DVA impact whether a valuation input is observable for the purposes of recognition of day one gain?

Under IAS 39, the best evidence of the fair value of a financial instrument at initial recognition is its transaction price, unless the fair value of an instrument is evidenced by comparison with other observable current market transactions in the same instrument or based on a valuation technique that includes only data from observable markets.

IFRS 13 has not substantively changed the threshold for the recognition of day one gains and losses. It reiterates that the transaction price is normally the best evidence of the fair value of a financial instrument on initial recognition. However, there may be cases in which it is appropriate for a bank to conclude that the fair value at initial recognition is different from the transaction price. If the bank determines that the fair value on initial recognition differs from the transaction price but that this fair value measurement is not evidenced by a valuation technique that uses only data from observable markets, then the carrying amount of the financial instrument on initial recognition is adjusted to defer the difference between the fair value measurement and the transaction price.

In our experience, common methods for calculating DVA on certain derivatives (e.g. with long-dated maturities, deep in- and out-of-the-money options etc) are typically based on unobservable inputs. When this is the case, a question may arise over whether the inclusion of such unobservable inputs prevents the recognition of day one gains.

In our experience, banks may consider the recognition of day one gains if any unobservable inputs used in the valuation technique that forms the basis for determining the instrument's fair value at initial recognition are judged to be insignificant in relation to measuring the day one gain.

Does IFRS 13 significantly change fair value disclosures?

IFRS 13 expands the existing disclosure requirements for financial instruments that are currently included in IFRS 7. Examples of new or expanded disclosures include additional disclosures in respect of fair value measurements categorised as Level 3:

- quantitative information about significant unobservable inputs for recurring and non-recurring fair value measurements;
- a description of the valuation process used by the bank for recurring and non-recurring fair value measurements;
- a narrative description of the sensitivity of the fair value measurements to changes in unobservable inputs and inter-relationships between unobservable inputs for recurring fair value measurements; and
- the disclosure of gains or losses recognised in other comprehensive income and of unrealised gains and losses for recurring fair value measurements.

Other disclosure requirements introduced by IFRS 13 are:

- all transfers (not just significant ones) between Level 1 and Level 2 of the fair value hierarchy and the reasons for those transfers;
- for each class of assets and liabilities not measured at fair value in the statement of financial position but for which the fair value is disclosed, the level of the fair value hierarchy within which the fair value measurements are categorised; and
- when an entity concludes that the transaction price was not the best evidence of the fair value at initial recognition, the reasons for this conclusion and a description of the evidence that supports the fair value.

The IFRS 13 extended disclosure requirements are likely to require changes to banks' systems and processes. Banks that prepare interim reports have already had to gather the necessary information.

Challenges ahead

The magnitude of the challenge of implementing IFRS 13 will depend on a bank's existing approach under IAS 39/IFRS 9 and the nature of its business and the financial instruments held. For some banks, the resulting changes may be extensive. In addition, banks will have to monitor emerging practice in some difficult areas of interpretation discussed above.

REGULATION IN ACTION: COMPARING BASEL WITH THE IASB ED ON EXPECTED CREDIT LOSSES

Following the issue by the IASB of its exposure draft ED/2013/3 *Financial Instruments: Expected Credit Losses* (the ED) in March 2013, many banks have been focusing on identifying crossovers and synergies between the proposals in the ED and the credit risk parameters (probability of default (PD), loss given default (LGD) and exposure at default (EAD)) used for regulatory calculations under the Basel capital framework.

The ED proposes a step change in accounting for credit losses

The ED proposes a new 'expected credit loss' impairment model that would reflect deterioration in the credit quality of financial assets. Under the model, lifetime expected credit losses would generally be recognised for financial assets whose credit risk has deteriorated significantly since initial recognition, and 12-month expected credit losses for other financial assets.

The ED does not define what is meant by '12-month expected credit losses', beyond proposing that they are the expected credit losses resulting from default events on the financial instrument that are possible within the 12 months after the end of the reporting period. It proposes that entities may apply various approaches – including those that do not include an explicit PD occurring as an input – as long as such approaches comply with the general requirements of the ED. Neither does the ED define the term 'default'. The limited guidance proposes that an entity has to have a consistent definition of default, which may include one or several events. Different entities could use different definitions of default, including, when applicable, a regulatory definition.

In the basis for conclusions to the ED, the IASB notes that in many jurisdictions financial institutions already calculate a 12-month loss rate for regulatory requirements that is similar to the proposals in the ED, and so implementing the model would be less costly for them. However, it also acknowledges that an entity would have to adjust these regulatory measurements to comply with the proposed requirements in the ED. In practice, there are likely to be many differences between the two sets of requirements.

Basel – Reflecting expected credit losses in regulatory capital

Banks applying the Basel Standardised approach are required to use regulator-prescribed risk weight values and so would have a limited ability to use the regulatory calculations to arrive at ED-compliant data. Banks applying the Foundation IRB approach[2] (FIRB) that use internal models to estimate the PDs (with LGDs and EADs being prescribed by the regulator) may be able to use the data and systems applied for the regulatory PD estimates in their accounting calculations, subject to a range of adjustments to reflect the differences between the accounting and the regulatory requirements. Finally, banks applying the Advanced IRB approach (AIRB) that are permitted to use internally developed models to calculate PDs, LGDs and EADs for their regulatory capital requirements are likely to have the largest scope for using their existing data, internal models and systems to arrive at expected credit loss estimates that comply with the proposals of the ED.

The question that arises is to what extent the regulatory credit risk parameters (or inputs used to derive these parameters) may be used for determining expected credit losses that are compliant with the proposals of the ED.

2 IRB approach: internal-ratings based approach in the Basel regulatory framework.

Comparing the accounting and regulatory models

We highlight below some of the key differences between these two sets of requirements, assuming that a bank uses the AIRB approach for calculating its regulatory capital requirements.

	The ED	Basel
PD – Period over which it is estimated	Depending on the asset, the PD would be measured either: • for the next 12 months; or • for the remaining life of the financial instrument.	One measure is used – i.e. PD for the next 12 months. However, in certain cases (e.g. low-default portfolios) multi-period PD over various time horizons may be considered to determine an effective 12-month PD.
PD – Point at which it is estimated	PD estimates would be 'point-in-time' measures, based on actual expectations at the end of the reporting period.	PD estimates could be based on internal rating methodologies that are anywhere on the spectrum from 'point-in-time' to 'through-the-cycle'[3]. In all cases, the estimates will be based on historical long-run default rates.
Definition of default	There is no definition of the term 'default'. It may include one or several events, including, when applicable, a regulatory definition.	Under Basel, a default has occurred if either or both of the following two events has taken place: • it is unlikely that the obligor will be able to repay its debt to the bank in full without recourse by the bank to actions such as realising collateral; and/or • the obligor is more than 90 days past due[4] on a material credit obligation.
Floor in the calculation	The ED does not propose a floor on the calculation of credit losses.	PD and LGD estimates for certain types of exposures are subject to a regulatory prescribed floor.
Discount rate	The discount rate for a financial asset would be determined at initial recognition as being any reasonable rate between, and including, the risk-free rate and the effective interest rate (EIR). The discount rate for loan commitments and financial guarantees would be a rate that reflects the current assessment of the time value of money and the risks specific to the cash flows, when appropriate. Once a financial asset is credit-impaired, the EIR would be used as the discount rate.	The bank may use a risk-free rate for discounting if the cash flows arising from collateral have been subject to haircuts sufficient to adjust for the potential volatility of the collateral value in downturn economic conditions. Otherwise, the bank should use a rate that reflects the uncertainty in cash flows and the time value of money.

3 'Through-the-cycle' approach: an approach that seeks to determine credit rating grades that remain stable through an economic cycle.

4 In the case of retail and public sector exposures, a supervisor may substitute the 90-day threshold with up to 180 days for different products, as it considers appropriate for the local conditions.

	The ED	Basel
Collateral	The estimate of expected cash flows on a collateralised asset would reflect: • the cash flows that may result from foreclosure; less • costs for obtaining and selling the collateral, irrespective of whether foreclosure is probable.	A bank may incorporate any collateral within its LGD estimation provided it has sufficient data to support the LGD modelling methodology that it determines in line with the regulatory requirements. The collateral values have to be adjusted for volatility.
Observation period	The ED has no specific requirements about the observation period for the collection of historical data that is used for the calculations.	The minimum observation period for LGD and EAD is five years for retail exposures and seven years for sovereign, corporate and bank exposures.
Expected credit losses – Mechanics of calculation	The mechanics of the calculation would depend on the nature of the financial instrument and would be different for: • financial assets that are not credit-impaired; • financial assets that are credit-impaired; and • loan commitments and financial guarantees. The estimate of contractual cash flows included in the calculations would include consideration of prepayment, call and similar options. Loan commitments would be included only if there is a present contractual obligation to extend credit.	Expected losses are calculated by applying the loss rate (PD x LGD) to the EAD. The EAD is the exposure expected to be outstanding should the facility default in the next year. It includes the estimate of expected future draw-downs through credit conversion factors (percentage of the currently undrawn limit that will be drawn down at the time of default). The EAD is calculated on a downturn economic basis.
Economic assumptions for estimating credit losses	Estimates of expected credit losses would reflect an unbiased probability-weighted amount that is determined by evaluating a range of possible outcomes. It would be neither an estimate of a worst-case scenario nor a best-case scenario.	Expected losses reflect downturn LGD and EAD – i.e. values that are worst-case figures factoring in macroeconomic stressed conditions.

The table above highlights some of the differences between the two approaches to calculating expected credit losses. However, it is not an exhaustive list and, in practice, the nature and number of the differences will depend on many factors, including:

- the nature of a bank's products and business;
- how Basel 2 and 3 have been implemented in a particular jurisdiction and by the bank; and
- the decisions made by the bank to implement the final IASB requirements.

Clearly, there are considerable benefits from leveraging Basel data, systems and processes to calculate the information required for financial statements. However, the extent of the work that may be needed to arrive at IFRS-compliant figures should not be underestimated.

WHERE REGULATION AND REPORTING MEET …

EU arrives at final agreement on CRD IV package

We commented in previous issues of *The Bank Statement* on some of the accounting implications arising from the implementation of Basel 3 (see *The Bank Statement* Q4 2012 and Q1 2013). Implementation of the new Basel 3 requirements in the EU came a step closer in June 2013 when the CRD IV (Capital Requirements Directive) – a package that will provide a framework for the translation of Basel 3 into EU legislation – was published in the *EU Official Journal*.

The CRD IV package incorporates the following:

- CRR (Capital Requirements Regulation), which will apply directly to every EU member state; and
- CRD, which will need to be transposed into local legislation.

CRD IV goes beyond the requirements of Basel 3 and covers areas such as corporate governance, remuneration, sanctions and a broader set of tools to address systemic risk. Some of the related accounting implications that banks may have to consider are set out below.

CRD IV requirement	Potential accounting considerations
Regulatory capital	Disclosures relating to capital under IAS 1 *Presentation of Financial Statements*
Leverage ratio	Classification of financial instruments under IAS 39, such as held to maturity (see *The Bank Statement* Q4 2012)
Employee remuneration	Accounting for employee benefits under IAS 19 *Employee Benefits* and for share-based payments under IFRS 2 *Share-based Payment*
Regulatory capital and liquidity ratio	Proposals in ED/2012/4 *Classification and Measurement: Limited Amendments to IFRS 9* (see *The Bank Statement* Q1 2013)
Regulatory capital – Definition of default	Proposals in ED/2013/3 *Financial Instruments: Expected credit losses*

EBA issues proposals for regulatory reporting on asset encumbrance and on forbearance and non-performing exposures

On 26 March, the European Banking Authority (EBA) issued two consultation papers related to regulatory reporting on asset encumbrance and on forbearance and non-performing exposures. The consultation period for the papers ended on 1 July and 24 June respectively.

EBA/CP/2013/05 consultation on regulatory reporting for asset encumbrance

The EBA consultation was launched to complement the existing framework on regulatory reporting for asset encumbrance. The proposals discuss, inter alia:

- the definition of asset encumbrance; and
- the introduction of additional regulatory reporting templates.

Under the proposals, regulatory reporting for asset encumbrance would be based on accounting values (i.e. carrying amounts in the financial statements), supplemented with fair value information. Disclosures in this area are already required/recommended by:

- IFRS 7 – e.g. requirements in respect of financial assets pledged as collateral, certain collateral held, financial assets transferred (those that have not been derecognised and those that have been derecognised in their entirety but with which the bank has continuing involvement), or financial assets subject to master netting or similar agreements;
- the Enhanced Disclosure Task Force's report, *Enhancing the Risk Disclosures of Banks*, issued in October 2012 – e.g. disclosures related to funding; and

- local regulators – e.g. the Prudential Regulation Authority (PRA) in the UK requires disclosures on asset encumbrance as part of liquidity and funding risk disclosures.

EBA/CP/2013/06 consultation on regulatory reporting on forbearance and non-performing exposures

The EBA proposals for regulatory reporting on forbearance and non-performing exposures discuss:

- the definitions of forbearance and non-performing loans; and
- the introduction of additional regulatory reporting templates.

Disclosures in this area have already been recommended by regulators in the past. For example, in December 2012 the European Securities and Markets Authority (ESMA) issued a public statement, *Treatment of Forbearance Practices in IFRS Financial Statements of Financial Institutions*, which discusses accounting and disclosures relating to forbearance. Regulators in various jurisdictions have issued their own guidance – e.g. the Financial Services Authority (FSA[5]) in the UK and the *Autorité des Marchés Financiers* (AMF[6]) in France.

The EBA notes the lack of existing harmonised definitions of the terms 'forbearance' and 'non-performing', and it explains that its proposed definitions build on the existing accounting and regulatory provisions. The proposed definitions would apply to:

- all loans and debt securities that are on-balance sheet, irrespective of their measurement basis for accounting purposes; and
- off-balance sheet items, including financial guarantees and loan commitments.

There is a potential overlap between the proposals and the measurement and disclosure requirements in respect of impairment of financial assets included in IAS 39 and IFRS 7. In addition, it appears that the proposals would cover all financial instruments, including those measured at fair value through profit and loss. IAS 39 and IFRS 7 do not require the recognition of impairment or impairment disclosures in respect of such items.

The EBA expects to finalise the requirements by Q3 2013.

Impact on banks

Given the volume of required additional reporting in the proposals and the potentially short implementation period, banks may need to assess their ability to source the required data. They may need to consider to what extent the information that would be required under the proposals overlaps with the information already produced for their financial statements, and what reconciliations would be required between the regulatory and the accounting disclosures to ensure that there are no unexplained differences between them. They would also need to consider how they can use their existing systems and processes to prepare the regulatory information that would be required under the proposals. The divergence between the accounting and regulatory reporting requirements may present considerable challenges in ensuring consistency between various reporting requirements and in articulating the differences.

5 FSA: ex-financial services regulator in the UK.
6 AMF: the stock market regulator in France.

YOU ALSO MAY BE INTERESTED TO READ …

In the Headlines: Continuing hedge accounting after derivative novations – Issue 2013/13

Highlights the IASB's amendments to IAS 39 to provide relief from hedge accounting discontinuation.

June 2013

In the Headlines: Liabilities for levies – Issue 2013/09

Provides a high-level summary of the guidance in IFRIC Interpretation 21 *Levies* issued by the IASB.

May 2013

In the Headlines: Reminder: Effective dates of IFRS – Issue 2013/10

A reminder of newly effective standards and standards issued but not yet effective for annual reporting periods ending on or after 30 June 2013, and interim periods within these annual reporting periods.

June 2013

IFRS Newsletter: Financial Instruments – Issues 11, 12 and 13

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

April 2013, May 2013 and June 2013

IFRS Newsletter: Revenue – Issue 9

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

May 2013

In the Headlines: Insurance – Issue 2013/11

Explains at a high level the IASB's proposals on insurance accounting in ED/2013/7 *Insurance Contracts*.

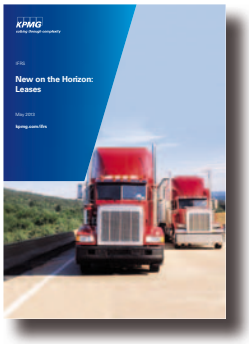
June 2013

In the Headlines: Leases – Issue 2013/08

Highlights the Boards' proposals in ED/2013/6 *Leases*.

May 2013

New on the Horizon: Leases



Discusses the Boards' proposals in ED/2013/6 *Leases* on the dual model for leases and the resulting impact on the profile of lease income or expense.

May 2013

FVA – Putting Funding into the Equation

Discusses current thinking on some of the key open topics and seeks to enhance awareness in relation to FVA.

June 2013

Click on the images above to access the publications

BANKING CONTACTS

Global Head of Banking
David Sayer
KPMG in the UK
T: +44 20 7311 5404
E: david.sayer@kpmg.co.uk

Global Head of Capital Markets
Michael J Conover
KPMG in the US
T: +1 212 872 6402
E: mconover@kpmg.com

Argentina
Mauricio Eidelstein
T: + 54 11 43165793
E: geidelstein@kpmg.com.ar

Australia
Adrian Fisk
T: +61 2 9335 7923
E: adrianfisk@kpmg.com.au

Brazil
Fernando Alfredo
T: +55 11 21833379
E: falfredo@kpmg.com.br

Canada
Mahesh Narayanasami
T: +1 416 777 8567
E: mnarayanasami@kpmg.ca

China
Caron Hughes
T: +85 22 913 2983
E: caron.hughes@kpmg.com

France
Jean-François Dandé
T: +33 1 5568 6812
E: jeanfrancoisdande@kpmg.fr

Germany
Andreas Wolsiffer
T: +49 69 9587 3864
E: awolsiffer@kpmg.com

India
Manoj Kumar Vijai
T: +91 22 3090 2493
E: mkumar@kpmg.com

Israel
Danny Vitan
T: +972 3 684 8000
E: dvitan@kpmg.com

Italy
Roberto Spiller
T: +39 026 7631
E: rspiller@kpmg.it

Japan
Tomomi Mase
T: +81 3 3548 5102
E: Tomomi.Mase@jp.kpmg.com

Korea
Michael Kwon
T: +82 2 2112 0217
E: ykwon@kr.kpmg.com

Mexico
Ricardo Delfin
T: +52 55 5246 8453
E: delfin.ricardo@kpmg.com.mx

Netherlands
Peti De Wit
T: +31 206 567382
E: dewit.peti@kpmg.nl

Portugal
Ines Viegas
T: +35 121 011 0002
E: iviegas@kpmg.com

Singapore
Reinhard Klemmer
T: +65 6213 2333
E: rklemmer2@kpmg.com.sg

South Africa
Vanessa Yuill
T: +27 11 647 8339
E: vanessa.yuill@kpmg.co.za

Spain
Ana Cortez
T: +34 91 451 3233
E: acortez@kpmg.es

Sweden
Anders Torgander
T: +46 8 7239266
E: anders.torgander@kpmg.se

Switzerland
Patricia Bielmann
T: +41 44 249 4884
E: pbielmann@kpmg.com

UK
Colin Martin
T: +44 20 73115184
E: colin.martin@kpmg.co.uk

US
Michael Hall
T: +1 212 872 5665
E: mhhall@kpmg.com

Acknowledgements

We would like to acknowledge the efforts of the principal authors of this publication: Ewa Bialkowska, Colin Martin and Arevhat Tsaturyan.

KPMG International Standards Group is part of KPMG IFRG Limited.

Publication name: *The Bank Statement*

Publication number: Issue 10

Publication date: July 2013

kpmg.com/ifrs

***The Bank Statement* is KPMG's update on accounting and reporting developments in the banking sector.**

If you would like further information on any of the matters discussed in this Newsletter, please talk to your usual local KPMG contact or call any of KPMG firms' offices.