



The accounting black box: banking sector disruption

As banks wrestle with the challenges wrought by several new accounting standards, Bhaskar Sahay focuses on three of the most critical issues that he expects to affect the business, risk management, and the credit functions, respectively.

After a few years of contending with sweeping accounting and regulatory changes in the wake of IFRS 9 *Financial Instruments*, IFRS 16 *Leases*, and IFRS 15 *Revenue from contracts with customers*, the financial services sector could claim some downtime before bracing for the next wave of challenges. 2019 saw considerable merger related activity, whereby banks' chief financial officers (CFOs) continued to burn the midnight oil as they grapple with potential accounting complexities in a rapidly evolving business environment.

Given the relatively low liquidity in the sector, corporates have been working with banks to structure factoring-type arrangements. The objective is to offload trade receivables from corporates' balance sheets. The transactions

are aimed towards achieving lighter, more streamlined balance sheets. They may also increase the corporates' ability to approach banks for additional funding.

The de-recognition requirements should be carefully analyzed to ensure there is a substantial transfer of risks and rewards relating to the de-recognized portfolios. One of the issues to consider, for the corporate entity seeking to lighten its balance sheet, is to decide whether the cash flows to the financial instruments have expired. If this is the case, the solution is uncomplicated.

In case they have not expired, an analysis is required to assess whether the corporate entity has transferred its right to collect the proceeds from debtors (to the bank that undertakes factoring) or has assumed an obligation to pay the

proceeds to another entity (the factoring bank). If either of this is true, the corporate is required to assess if there has been a substantial transfer of risks and rewards. This is done by comparing the corporates' exposure before and after the transfer, to the variability in the present value of the future net cash flows from the assets being derecognized.

In many instances, one of the risk factors is credit risk. Assessing if substantial risk and reward has been transferred is complex and often includes the use of judgement, statistical techniques, and estimation. The existence of recourse, credit guarantees, or enhancements may affect the analysis, and their impact needs are to be carefully considered. The theory is relatively simple but putting the principles into practice requires careful deliberation.

Consolidation of special purpose vehicles

In the same vein as the factoring, banks may also be expected to seek avenues to offload their non-core assets (i.e. property, plant and equipment, as well as land and property classified as investment property) from their balance sheet. This is aimed at strengthening their balance sheets, monetization, and improving regulatory and other market related ratios. However, given the consolidation requirements of IFRS 10 Consolidated financial statements, due care needs to be taken to understand that any assets that are de-recognized do not get added back to the asset base through the consolidation process. The nature and purpose of the set-up of these vehicles may render them vulnerable to failing to meet the consolidation requirements. If the transferee entities are consolidated, the purpose of the transfer is not met.

Two years have now passed since the implementation of IFRS 9. While many banks have validated their expected credit loss (ECL), models, a complete assessment of the functioning and the impact on the bank's behavior and, in turn, of financial stability, requires time evidence and reliable data. The validation process is coming under increased scrutiny from regulators, with stakeholders paying close attention to risk management, especially possible reputational repercussions for the bank. Given that two incremental years' worth of additional data is now available, banks need to focus on those aspects of the expected ECL that could potentially contribute to procyclical behavior, the conditions under which such behavior is expected to arise, and what steps should be taken to address it. Models are expected to be validated and benchmarked with external comparable sources.

Another important point for banks to consider is the competence and independence of the model validation team, which is likely to operate within a robust governance framework. Banks aim to implement a framework where they are able to include scenario-based analyses and build a unified framework for stress testing, IFRS 9 and business/capital planning.

Lens of the credit function: leasing

Following the discussion of IFRS 16 IN 2019, discussion on accounting issues could not conclude without the judgments, estimates, data gathering, disclosures and accounting for leases under IFRS 16. IFRS 16 results in recognition of all leases on the balance sheet. This resulted in grossing up of the balance sheet with a right-of-use asset and corresponding lease liability. While the impact of IFRS 16 has generally not been very material

given the size of a typical bank's balance sheet, IFRS 16 has had a more significant impact on borrowers. The credit department should understand the nuances of IFRS 16 implementation, striving to ensure that customers' financial statements are appropriately evaluated.

This requires an assessment of the practical expedients applied, judgements, estimates and disclosures. For two entities' business performance to be comparable, judgments on the lease tenure, discount rates, variability clauses in leases, lease definition and the efficient use of practical expedients should be considered concurrently.

The alignment of accounting with risk management has resulted in accounting issues being closely integrated to business needs and, in certain instances, becoming deal breakers for potential transactions. 2020 is expected to be an exciting year for the industry, and we are optimistic about the opportunities available to meet the accounting and regulatory needs of the evolving banking sector.

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