THE BANK STATEMENT
Q1 2014 NEWSLETTER

cutting through complexity

"After accepting discounting using the overnight index swap rate as the new normal for collateralised derivatives, the market has shifted its attention to uncollateralised positions. At its heart, funding valuation adjustment is an attempt to value a derivative considering all of the associated cash flows, including any collateral requirements."

Colin Martin
Head of UK Assurance Services, Banking, KPMG

EFFECTIVE DATE FOR IFRS 9 AND CHALLENGES AHEAD IN ACCOUNTING FOR FUNDING VALUE ADJUSTMENTS

Welcome to the Q1 2014 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 has tentatively decided that **IFRS 9** *Financial Instruments* will be effective for **annual periods beginning on or after 1 January 2018** – see page 2.
- The IASB expects to issue the remaining chapters of **IFRS 9 in Q2 2014** – see page 2.
- Market practice for pricing derivatives is evolving. We discuss some accounting issues related to the **inclusion of funding into valuation estimates** – see page 6.
- **New section on benchmarks:** We have looked at the financial statements issued by 10 banks reporting under IFRS to compare their **new disclosure of the fair value hierarchy of financial instruments carried at amortised cost**, such as loans – see page 8.
- The European Banking Authority issues proposals for **disclosure of asset encumbrance**. We consider some possible interactions with disclosure requirements under IFRS – see page 10.

IASB ACTIVITIES AFFECTING YOUR BANK

Mandatory effective date of IFRS 9

The IASB has tentatively decided that IFRS 9 *Financial Instruments* will be effective for annual periods beginning on or after 1 January 2018.

Also, in finalising IFRS 4 *Insurance Contracts,* the IASB will consider the need for additional transition relief so that entities that issue insurance contracts would not be disadvantaged if they are required to apply IFRS 9 before they apply IFRS 4.

Financial instruments: Classification and measurement

At its January 2014 meeting, the IASB discussed the following remaining aspects of the proposals in its exposure draft ED/2012/4 *Classification and Measurement: Limited Amendments to IFRS 9* (the limited amendments ED):

- the interaction with the accounting for insurance contracts;
- presentation and disclosures; and
- transition.

Interaction with the accounting for insurance contract liabilities

The Board noted that the proposals in the limited amendments ED that were tentatively reaffirmed during the deliberations would result in an improved interaction with the accounting for insurance contracts. It decided to consider, during redeliberation of exposure draft ED/2013/7 *Insurance Contracts,* the feedback on the accounting model for insurance contract liabilities, and whether that model should be modified to reflect the interaction with the classification and measurement of financial assets.

Presentation and disclosures

The IASB tentatively decided to extend the existing requirements in IFRS 7 *Financial Instruments: Disclosures* on reclassification of financial assets to include information relating to reclassification into and out of fair value through other comprehensive income (FVOCI).

In addition, the judgement involved in assessing an asset's contractual cash flow characteristics would be added to paragraph 123 of IAS 1 *Presentation of Financial Statements* as an example of a judgement that could have a significant effect on the amounts recognised in the financial statements.

Transition

The Board discussed:

- the presentation of comparative information by first-time adopters of IFRS;
- early application of IFRS 9; and
- selected requirements on transition to the completed version of IFRS 9.

First-time adopters would not be required to present comparative information that complies with the completed version of IFRS 9 if the beginning of their first IFRS reporting period is earlier than the mandatory effective date of IFRS 9 plus one year.

Early application of the completed version of IFRS 9 would be permitted for both first-time adopters and existing IFRS reporters. Early application of previous versions would not be permitted if the date of initial application is six months or more after the completed version of IFRS 9 is issued in Q2 2014.

The discussion of the transition provisions included the application of certain 'impracticable' exemptions, and application and revocation of fair value option designations for entities that have already applied a previous version of IFRS 9.

Financial instruments: Impairment

In January 2014, the Board discussed the presentation and disclosure proposals in exposure draft ED/2013/3 *Financial Instruments: Expected Credit Losses* (the impairment ED) and tentatively decided to retain the majority of the proposed disclosures. Some of the key changes included:

- clarifying that the objective of the reconciliation between the gross opening and closing balance of financial assets is to provide information about key drivers for change;
- clarifying that quantitative information about the extent to which collateral or other credit enhancements affect the expected credit loss allowance (or provision) does not require providing information about the fair value of collateral;
- requiring disclosure of the gross carrying amount of modified financial assets for which the measurement of the credit loss allowance has changed from lifetime expected credit losses to 12-month expected credit losses only in the period of change;
- requiring disclosure of the nominal amount of assets written off but subject to enforcement activity only for financial assets that have been written off during the period;
- modifying the requirement in paragraph 44 of the impairment ED to allow the use of an ageing analysis to assess significant increases in credit risk for financial assets for which delinquency information is the only borrower-specific information available; and
- removing the requirement in paragraph 44 of the impairment ED that an entity disaggregate its financial instruments across at least three credit grades; instead, requiring credit risk disaggregation to be aligned with the way credit risk is managed internally and requiring a consistent approach to be applied over time.

The Board also tentatively agreed that the transition provisions on the initial application of the expected credit loss model for existing IFRS preparers (see the Q4 2013 issue of *The Bank Statement*) would also be required for first-time adopters.

Next steps

The staff will proceed to draft and ballot both the limited amendments to the classification and measurement requirements and the final requirements for impairment to be incorporated into IFRS 9. The IASB expects to issue the remaining chapters of IFRS 9 in Q2 2014.

Narrow-scope amendments to IFRS 10

In March 2014, the IASB discussed proposed amendments to IFRS 10 *Consolidated Financial Statements* that had been discussed by the IFRS Interpretations Committee in January 2014 and November 2013 (see the Q4 2013 issue of *The Bank Statement*). These proposals relate to the following:

- an investment entity subsidiary that also provides investment-related services to third parties; and
- the applicability of the exemption from preparing consolidated financial statements in IFRS 10.

An investment entity subsidiary that also provides investment-related services to third parties

The IASB discussed whether an investment entity parent should account for an investment entity subsidiary at fair value, when that investment entity subsidiary provides investment-related services to third parties. The IASB tentatively decided to continue to develop an amendment to IFRS 10 to confirm that all investment entity subsidiaries should be measured at fair value through profit or loss.

Applicability of the exemption from preparing consolidated financial statements in IFRS 10

The IASB tentatively decided to amend IFRS 10 to confirm that the exemption from preparing consolidated financial statements set out in paragraph 4(a) of IFRS 10 should be available to an intermediate parent entity that is a subsidiary of an investment entity but that is not an investment entity itself.

Financial instrument that is mandatorily convertible into a variable number of shares on a contingent 'non-viability' event

In January 2014, the IFRS Interpretations Committee discussed how an issuer should classify in accordance with IAS 32 *Financial Instruments: Presentation* a particular financial instrument that did not have a stated maturity date but was mandatorily convertible into a variable number of the issuer's own equity instruments if the issuer breached the Tier 1 capital ratio – described as a 'contingent non-viability event'. Interest payments on the instrument were at the discretion of the issuer. This was an issue originally discussed by the Committee in its July 2013 meeting (see the Q3 2013 issue of *The Bank Statement*), following which the Committee published a tentative agenda decision.

Specifically, the issues discussed were:

- whether the financial instrument meets the definition of a financial liability in its entirety or has to be classified as a compound instrument comprised of a liability component and an equity component – and, in the latter case, what those components reflect; and
- how the financial liability – or liability component – identified above would be measured.

The Committee noted that the scope of the issue is too broad for it to address in an efficient manner and therefore decided not to add this issue to its agenda.

Financial instrument that is mandatorily convertible into a variable number of shares (subject to a cap and a floor) but gives the issuer the option to settle by delivering the maximum (fixed) number of shares

In January 2014, the IFRS Interpretations Committee also discussed how an issuer would assess the substance of a particular early settlement option included in a financial instrument in accordance with IAS 32.

The instrument has a stated maturity date, and at maturity the issuer has to deliver a variable number of its own equity instruments to equal a fixed cash amount, subject to a cap and a floor. The issuer is required to pay interest at a fixed rate, and has the contractual right to settle the instrument at any time before maturity. If the issuer chooses to exercise that early settlement option, then it has to:

- deliver the maximum number of equity instruments specified in the contract; and
- pay in cash all of the interest that would have been payable if the instrument had remained outstanding until its maturity date.

The Committee noted that judgement is required to determine whether the issuer's early settlement option is substantive. If it is not substantive, then the term would not be considered in determining the classification of the financial instrument. The Committee also noted that to determine whether the early settlement option is substantive, the issuer will need to understand whether there are actual economic or other business reasons that the issuer would exercise the option. The guidance in paragraph 20(b) of IAS 32 is relevant because it provides an example of a situation in which one of an instrument's settlement alternatives is excluded from the classification assessment.

In light of the existing IFRS requirements, the Committee considered that neither an interpretation nor an amendment to a standard was necessary and therefore decided not to add the issue to its agenda.

Financial instrument that is mandatorily convertible into a variable number of shares subject to a cap and a floor

In January 2014, the IFRS Interpretations Committee discussed how an issuer would account for a particular mandatorily convertible financial instrument in accordance with IAS 32 and IAS 39 *Financial Instruments: Recognition and Measurement* or IFRS 9. The financial instrument has a stated maturity date and at maturity the issuer has to deliver a variable number of its own equity instruments to equal a fixed cash amount – subject to a cap and a floor, which limit and guarantee, respectively, the number of equity instruments to be delivered.

Although the variability is limited by the cap and the floor, the Committee noted that the number of equity instruments that the issuer is obliged to deliver is not fixed and therefore the instrument meets the definition of a financial liability in paragraph 11(b)(i) of IAS 32. The Committee also noted that IAS 32 does not permit an issuer to divide a conversion feature into multiple outcomes for the purposes of evaluating whether the instrument contains a component that meets the definition of equity.

The Committee noted that the cap and the floor are embedded derivative features. Therefore, assuming that the issuer has not elected to designate the entire instrument under the fair value option, the issuer has to separate those embedded derivative features from the host liability contract and account for them at fair value through profit or loss in accordance with IAS 39 or IFRS 9.

In light of the existing IFRS requirements, the Committee decided that an interpretation was not necessary and didn't add the issue to its agenda.

SOMETHING OLD, SOMETHING NEW: ACCOUNTING FOR FUNDING VALUATION ADJUSTMENTS

"With the ink barely dry on IFRS 13 and the desire of standard setters to see a single derivative price, along comes FVA with an apparently unsolvable conundrum."

Editorial by Colin Martin, Head of UK Assurance Services, Banking, KPMG

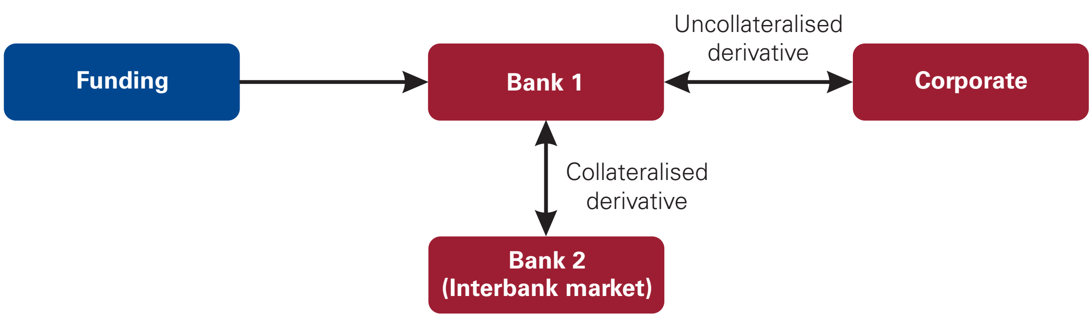
"Each firm must adjust the value of its book to reflect its access to and cost of funds (investing/funding rate) in various markets and currencies. Adjustments to mid-market for cost of funding should be dynamic, reflecting changes in the magnitude of expected investing/funding requirement and in each firm's cost of funds."

You could be forgiven for thinking that this quotation comes from a current issue of *Risk* magazine, so relevant is it to the latest hot topic in derivative fair value calculations. In fact, the recommendation comes from *Derivatives: Practice and Principles* by the Group of Thirty's Global Derivatives Study and dates back to 1993. Adjusting derivatives valuations for the cost of funding in a bank is clearly not a new phenomenon. However, to show that history has a sense of irony, this adjustment was rarely seen in the days when the recommendation was first made. The entities that had the most sophisticated infrastructure and models were the same entities that funded themselves at or close to LIBOR, reducing the need for an adjustment. For entities that funded themselves well away from LIBOR, there were no models to determine what adjustment might have been made. So there it sat, the forgotten man of derivative fair value adjustments, either too complex to do, or not that significant when it wasn't.

So what has changed?

The recent announcement by JP Morgan of a USD 1.5 billion debit to the income statement in respect of a funding valuation adjustment (FVA) associated with its uncollateralised derivative portfolio might be the tipping point that sees this adjustment enter the mainstream of derivatives valuation. So what has changed? The simplest answer is that the rate at which banks fund themselves hasn't been LIBOR flat for a while now, and this has focused the minds of bank staff everywhere on the issue of whether this change has an impact on the fair value of derivatives and, if so, on how to reflect this impact in the pricing. Although the concept of FVA brings out passionate debate on whether FVA is part of a derivative fair value, this article is not going to consider those arguments. Instead, it will focus on the IFRS challenges that making such an adjustment brings.

The market has accepted the new normal for collateralised derivatives in the form of discounting using the overnight index swap (OIS) rate such that most major banks have now moved their infrastructure to reflect this. It was only a matter of time before attention shifted to uncollateralised positions. At its heart, FVA is an attempt to value a derivative considering all of the associated cash flows, including any collateral requirements that may arise indirectly. Take a typical bank transacting a swap with a typical corporate. The corporate trade is uncollateralised and the derivative moves into the money for the bank. The bank will have hedged that transaction in the interbank market, which normally requires counterparties to provide collateral based on the market value of a trade. As a result, the bank will have an offsetting liability with a counterparty in the interbank market and will be required to post collateral against it. Any cash collateral will only earn the OIS rate, but the bank will have to bear the cost of funding that cash at its incremental funding rate – a rate that may be higher than LIBOR flat. That spread between the cost of funding and the return at OIS on its posted collateral is a real cost to the bank.



The result is that when transacting with a corporate, the bank factors in the potential extra funding spread that might arise. If this potential extra funding spread were not factored into the valuation of a derivative, then it would pop out of the valuation as an apparent day one gain.

Some of the challenges

So now to the part that will most challenge accountants. Clearly, if a bank incorporates its funding spread in the values of its derivatives, then that spread will be idiosyncratic to the institution itself. Not only that, but another bank with an identical contract with the same counterparty is likely to have a different funding spread, creating a different valuation for an almost identical contract. The same is true, of course, for so-called debit valuation adjustments (DVAs) in respect of own credit risk. However, in the case of DVA, standard setters came up with a neat solution to try and maintain the law of one price. IFRS 13 *Fair Value Measurement* requires an entity, in the absence of an observable price for transferring a liability, effectively to default to valuing its derivative liability in the way in which the counterparty values the corresponding asset. With the ink barely dry on IFRS 13 and the desire of standard setters to see a single derivative price (one entity's credit valuation adjustment (CVA) is another's DVA), along comes FVA with an apparently unsolvable conundrum.

IFRS 13 requires a contract to be recorded at the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. If different counterparties to a contract would value it at different prices because of their different incremental funding rates, then what is the exit price of the contract? Which counterparty do I assume that I will sell it to? Ignoring for a moment the huge technical challenges of which funding rate to use – incremental? based on a term structure? using a behaviouralised derivative life? – there seem to be two main schools of thought on this matter. Some entities argue that as a major and typical component of the market, their own funding spread is typical of other market participants. They would argue that using their own funding spread as a proxy for the market has merit. Others would argue that a market average should be taken to estimate the funding cost of the market as a whole. Neither option is perfect. The first technique uses what is an entity-specific input that might be dominated by entity-specific factors as a proxy for a market price. The second technique is akin to using a consensus price. Although it is an estimate, a value based on an average market rate would not be reflective of a sale of a contract to a market participant who isn't funding at the average market rate. The issue is further complicated by the fact that banks usually value derivatives on a portfolio basis, with FVA, DVA and CVA all potentially included in the mix and inter-related.

Furthermore, to increase complexity, the inclusion of FVA in the valuation of derivative instruments is likely to have an impact on hedging relationships and in particular on effectiveness testing and ineffectiveness measurement. This is because changes in the bank's funding spread would impact the measurement of changes in the fair value of a derivative hedging instrument and these changes may have no offsetting effect on the measurement of the changes in the value or cash flows of the hedged item attributable to the hedged risk. In addition, because a bank would probably make its FVA adjustments at a portfolio level for assessing hedge effectiveness and recognising ineffectiveness, it will have to allocate the adjustment to the individual hedging derivatives, or group of derivatives, that have been designated as the hedging instrument. In this respect, the bank will need to adopt a reasonable and consistent methodology for allocating FVA to individual derivative instruments.

Change gathers momentum?

Considering the ongoing debate surrounding whether and how FVA should be calculated for accounting purposes, few financial institutions have so far decided to incorporate FVA into valuation estimates. However, the tide may be turning as new voices emerge in the debate. For example, the International Valuation Standards Council (IVSC), in its exposure draft *Credit and Debit Valuation Adjustments* issued on 3 December 2013, discusses FVA in the context of fair value. Furthermore, the new *Draft Regulatory Technical Standards on Prudent Valuation*[1] published by the European Banking Authority (EBA) on 31 March 2014 requires banks to calculate a funding adjustment for regulatory purposes to reflect the valuation uncertainty when assessing the exit price according to the applicable accounting framework. Although the concepts of fair value and prudent valuation are different, these voices may drive the development and acceptance of methodologies for calculating FVA.

With some larger financial institutions and regulators beginning to recognise the adjustment, it may be that the tipping point for this particular market issue is already with us.

1 EBA/RTS/2014/06.

HOW DO YOU COMPARE? FAIR VALUE OF LOANS

Banks classified most loans and advances to customers into Level 3 of the fair value hierarchy

Many banks with 31 December year ends have now made the new fair value hierarchy disclosure of financial instruments carried at amortised cost, such as loans. We have looked at ten financial statements issued by banks reporting under IFRS to compare their disclosure in this area.

What's the issue?

Under IFRS 13, banks need to disclose the fair value of financial assets and financial liabilities measured on the balance sheet at amortised cost and the level in the fair value hierarchy within which such fair value measurements are categorised in their entirety For Level 2 and 3 valuations, banks have to provide a description of the valuation technique(s) and the inputs used in the fair value measurement as well as any changes in valuation techniques and reasons for making them.

IFRS 13 defines the levels in the fair value hierarchy as follows:

- Level 1 inputs: quoted prices (unadjusted) in active markets for identical assets or liabilities;
- Level 2 inputs: inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly; and
- Level 3 inputs: unobservable inputs.

The fair value measurement of a financial instrument is classified into Level 3 if any unobservable inputs are significant.

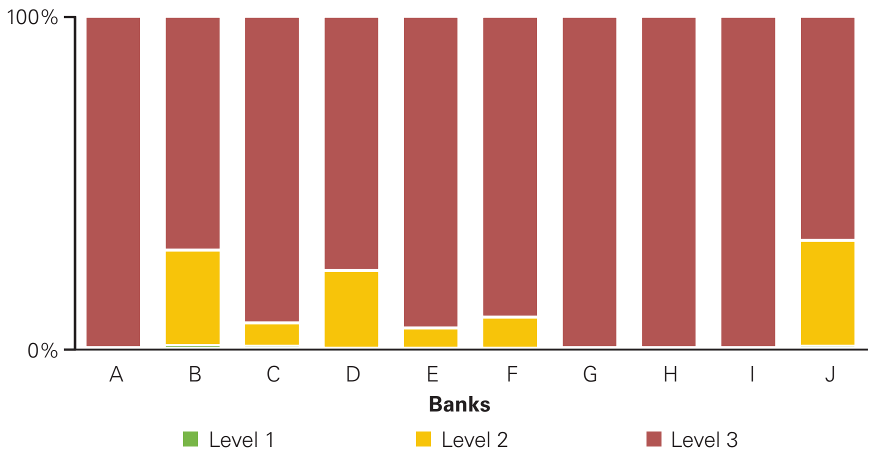
The lack of an actively traded market for the vast majority of loans and advances means that they are rarely categorised as Level 1. Also, judgement is often needed to determine the significance of unobservable inputs used in the valuation technique.

What conclusions did banks reach?

The banks in our sample categorised most of their loans and advances to customers into Level 3 (see Figure 1). However, there was greater variation in the categorisation of loans and advances to banks (see Figure 2).

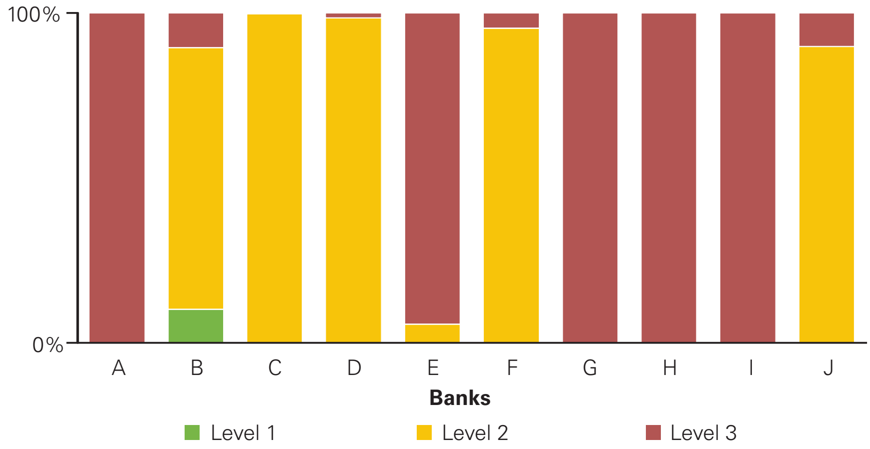
In general for loans not measured at fair value, banks in our sample did not provide a detailed explanation of the criteria used for determining the significance of unobservable inputs.

Figure 1: Loans and advances to customers[2]



2 Data in the charts is based on fair values at year end 2013.

Figure 2: Loans and advances to banks



What did they disclose?

Disclosures relating to the fair value of loans carried at amortised cost included the following.

- *Valuation techniques used:* Principally discounted cash flows, present value methods, value estimates from third party brokers reflecting over-the-counter trading activity and market transactions, where available.
- *Types of loans for which it has been assumed that carrying amount approximates fair value:* Floating-rate loans, lease financing transactions, short-term (six months to one year) fixed-rate loans.
- *Inputs into valuation techniques:* The majority mentioned interest rates and credit spreads as the main inputs; other inputs included were estimated prepayment rate and differentials between historical and current product margins.
- *Information by product type:* Principally mortgages, credit cards and corporate loans.

The data in the bar charts above excludes cash and demand balances with central banks and reverse repurchase agreements where these could be identified from the available disclosures. Generally, where banks made fair value hierarchy disclosures in respect of these assets, they categorised them as follows:

- cash and demand balances with central banks: Level 1 or Level 2; and
- reverse repurchase agreements: Level 2.

No bank in our sample differentiated in its disclosures between impaired and unimpaired loans.

REGULATION IN ACTION: EBA PROPOSALS FOR DISCLOSURE OF ASSET ENCUMBRANCE

European banks should consider the potential impact of the new disclosure requirements on asset encumbrance

What is the background to the proposals?

On 20 December 2013, the EBA issued the consultation paper *Draft guidelines on disclosure of encumbered and unencumbered assets* (EBA/CP/2013/48). The guidance is directed at institutions to which the disclosure requirements of Part Eight of Regulation (EU) No. 575/2013 (Pillar 3) apply.

The consultation paper has been prepared in response to the requirements of Article 443 of Regulation (EU) No. 575/2013 mandating the EBA to develop guidance on unencumbered assets. It intends to supplement the existing disclosure requirements for financial statements prepared in accordance with IFRS, especially those in IFRS 7 on assets pledged as collateral for liabilities, transferred assets and collateral held. It has been developed in co-operation with the European Securities and Markets Authority (ESMA) to provide a comprehensive view on asset encumbrance and harmonise the presentation. The proposed disclosures would be made in the same document as the disclosures required by Part Eight of Regulation (EU) No. 575/2013.

What are the proposals?

The consultation paper defines an 'encumbered asset' and proposes the following disclosures:

- narrative information on the impact of the institution's business model on the level of encumbrance and the importance of encumbrance in its funding model; and
- quantitative information.

The EBA notes that in developing the proposals, it had regard to the requirements in IFRS 7 and the recommendations of the Enhanced Disclosures Task Force (EDTF) report *Enhancing the Risk Disclosures of Banks* issued in October 2012. The table below gives an overview of the proposals in the consultation paper and a high-level comparison with the requirements of IFRS 7, IAS 7 *Statement of Cash Flows* and the recommendations of the EDTF report.

	EBA consultation paper	IFRS	EDTF report
Location of the disclosure	• In the same place as other requirements of Part Eight of Regulation (EU) No. 575/2013 are disclosed; in a single location	• Audited financial statements	• Not specified
Definition of encumbered assets	• Assets pledged or subject to any form of arrangement to secure, collateralise or credit-enhance any on- or off-balance sheet transaction from which they cannot be freely withdrawn (page 11)	• No definition	• Assets pledged as collateral or that the entity believes it is restricted from using to secure funding, for legal or other reasons (Principle 19)

	EBA consultation paper	IFRS	EDTF report
Qualitative disclosures	• Narrative information on the impact of the institution's business model on the level of encumbrance and the importance of encumbrance in its funding model (page 14)	• Terms and conditions of collateral pledged (paragraph 14 of IFRS 7) • Certain information on transferred assets that are not derecognised in their entirety (paragraph 42D of IFRS 7)	• Description of the nature of other assets that are considered to be encumbered and unencumbered if the transactions are material to the bank – e.g. lien on the whole or part of a portfolio of assets
Quantitative disclosures – Format	• Three templates provided	• No specific format required	• No specific format required, but an example provided
Quantitative disclosures –Type of information	• Carrying amounts of encumbered and unencumbered assets (page 12) • Information on collateral received (page 13) • Sources of encumbrance (page 14)	• Carrying amount of assets pledged as collateral (paragraph 14 of IFRS 7) • Information on collateral held that can be sold or re-pledged (paragraph 15 of IFRS 7) • Information on transferred financial assets that are not derecognised in their entirety (paragraph 42D of IFRS 7) • significant cash and cash equivalents that are not available for use by the group (paragraph 48 of IAS 7)	• Summary of encumbered and unencumbered assets in a tabular format by balance sheet categories, including collateral received that can be rehypothecated or otherwise redeployed
Quantitative disclosures – Values	• Median values (page 14)	• Period-end data	• Period-end data

	EBA consultation paper	IFRS	EDTF report
Information scoped out	• Assets in insurance activities that back liabilities to policyholders • The amount of emergency liquidity assistance provided by central banks • Collateral swaps with central banks (page 13)	• Financial instruments outside the scope of IFRS 7	• Acknowledges that, in some circumstances, information about assets pledged to central banks as part of emergency liquidity assistance may be particularly sensitive and, as a result, would not be separately provided (page 44)

What happens next?

The comment period expired on 20 March 2014 and the EBA is required by the EU to issue its guidelines by 30 June 2014.

The EBA notes that the proposed guidelines are the first step in its disclosure framework and are intended to enable market participants to compare institutions in a clear and consistent manner. They will form the basis of the binding technical standards on more extensive disclosures that the EBA will develop by 2016. The guidelines will be reviewed after one year.

BCBS issues leverage ratio framework

In January 2014, the Basel Committee on Banking Supervision (BCBS) issued *Basel III Leverage Ratio Framework and Disclosure Requirements*. The document sets out the requirements that will apply from the date of publication of a bank's first set of financial statements on or after 1 January 2015.

The 'leverage ratio' is a non-risk-based measure calculated as follows.

$$\text{Leverage ratio} = \frac{\text{Capital exposure}}{\text{Exposure measure}}$$

Capital exposure = Tier 1 capital as defined by Basel III.

Exposure measure = total of on-balance sheet, derivative, securities financing transactions and off-balance sheet items. The measurement of the exposure will generally follow the accounting, subject to certain specific requirements – e.g. relating to derivatives or offsetting.

Banks will be required to publicly disclose their Basel III leverage ratio on a consolidated basis[3]. Either the disclosures will be included in the published financial statements or, at a minimum, the financial statements will have to provide a direct link to the completed disclosure on a bank's website or in its publicly available regulatory reports.

Sufficient detail will have to be provided to enable market participants to reconcile a bank's leverage ratio with its published financial statements. To facilitate consistency and ease of use of the disclosures, the BCBS agreed that internationally active banks will be required to publish their leverage ratio, including reconciliation to financial statements, according to a common set of templates.

BCBS issues disclosure standards on liquidity coverage ratio

In January 2014, the BCBS also issued *Liquidity coverage ratio disclosure standards*. Compliance with the disclosures by internationally active banks will be required from the date of publication of a bank's first set of financial statements on or after 1 January 2015. As with the leverage ratio, either the disclosures will be included in the published financial statements or, at a minimum, the financial statements will have to provide a direct link to the completed disclosures on a bank's website or in its publicly available regulatory reports.

The disclosure requirements comprise:

- quantitative information presented in the format of a common template; and
- other quantitative and qualitative information deemed necessary to provide market participants with a broader picture of a bank's liquidity position and disclose relevant information that is not captured by the standardised template.

The common disclosure template requires disclosure of high-quality liquid assets, cash outflows, cash inflows and liquidity coverage ratios. The BCBS suggests that additional quantitative and qualitative information that banks may consider disclosing include the following.

Quantitative information:

- concentration limits on collateral pools and sources of funding;
- liquidity exposures and funding needs at the level of individual legal entities, foreign branches and subsidiaries, taking into account legal, regulatory and operational limitations on the transferability of liquidity; and
- balance sheet and off-balance sheet items broken down into maturity buckets and the resultant liquidity gaps.

3 The Basel III leverage ratio framework follows the same scope of regulatory consolidation as is used for the risk-based capital framework.

Qualitative information:

- governance of liquidity risk management, including: risk tolerance, structure and responsibilities for liquidity risk management, internal liquidity reporting, and communication of liquidity risk strategy, policies and practices across business lines and to the board of directors; and
- funding strategy, including policies on diversification in the sources and tenor of funding, and whether the funding strategy is centralised or decentralised.

Banks will have to consider how the new BCBS disclosure requirements interact with the requirements of IFRS 7 and the disclosures recommended by the EDTF report. The table below gives a high-level comparison of the respective requirements.

	BCBS	IFRS 7	EDTF report
Location of the disclosure	• Either included in a bank's published financial report or as a 'direct and prominent' link • To be published at the same frequency as and concurrently with the financial statements	• Audited financial statements	• Not specified; could be annual reports and/or Pillar 3 reports
Qualitative disclosures	• Information necessary to provide market participants with a broader picture of a bank's liquidity position	• Objectives, policies and processes for managing liquidity risk and the methods used to measure the risk (paragraph 33)	• Description of how the bank manages its potential liquidity needs (Principle 18)
Quantitative disclosures	• Specific information required by a common template • Additional information deemed necessary to provide market participants with a broader picture of a bank's liquidity position	• Summary quantitative data based on the information provided internally to key management (paragraph 34) • Maturity analysis for non-derivative and certain derivative financial liabilities (paragraph 39)	• Analysis of the components of the liquidity reserve, ideally by providing averages and period-end balances and an explanation of possible limitations on the use of the reserve (Principle 18)

Banks will have to consider how best to comply with these requirements and where to make the required disclosures. If similar disclosures are not made in one document – e.g. financial statements or an annual report – then care will have to be taken to ensure that information is provided on a consistent basis. A challenge may arise if different disclosures are made by different teams – e.g. regulatory or accounting – potentially using different systems and processes to generate the data.

The EDTF report observed that better risk disclosure is an important step in rebuilding investors' confidence and trust in the banking industry. It noted that describing risks and risk management transparently helps to build confidence in a bank's management, and enhancing investors' understanding of banks' risk exposures and risk management practices may reduce risk premiums and contribute to broader financial stability. Accordingly, it is important that the information – although it is prepared in response to the requirements and recommendations of different bodies – is presented in such a way that different aspects of it can be understood as a whole, irrespective of the location of the specific element of the disclosure.

IVSC issues exposure draft with examples of bases of value

In January 2014, the IVSC issued an exposure draft, *Illustrative Examples Chapter 1 – Bases of Value*. It contains the first chapter of the IVSC project to provide examples for the valuation concepts and principles included in the *IVS Framework*. The project's purpose is to help practitioners better understand certain concepts by illustrating their application.

The *IVSC Framework* defines three principal bases of value:

- market value;
- investment value; and
- fair value.

The exposure draft explains the differences between the three bases of value and provides explanatory examples, including discussion of some of the differences that may arise with IFRS 13.

The comment period on the exposure draft closed on 31 March 2014.

YOU MAY ALSO BE INTERESTED TO READ …

IFRS Newsletter: Financial Instruments – Issues 19 and 20

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

January and February 2014

IFRS Newsletter: Revenue – Issue 11

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

October 2013

IFRS Newsletter: Leases – Issues 13 and 14

Highlights the recent discussions of the IASB and the FASB on some aspects of their lease accounting proposals published in 2013.

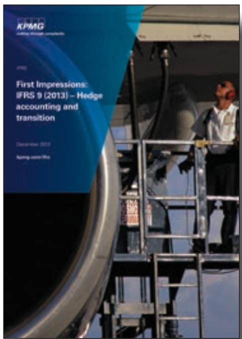
January and March 2014

IFRS Newsletter: Insurance – Issues 36, 37 and 38

Summarises the IASB's recent discussions on the insurance contracts project.

January, February and March 2014

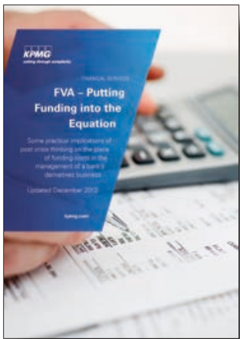
First Impressions: IFRS 9 (2013) – Hedge accounting and transition



Considers the requirements of the new general hedge accounting model in IFRS 9 *Financial Instruments* (2013).

December 2013

FVA – Putting Funding into the Equation – Updated December 2013



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

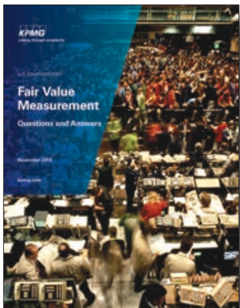
December 2013

In the Headlines: IFRS: New standards – Issue 2014/04

A summary of newly effective and forthcoming standards. This edition covers financial years ending on or after 31 March 2014, including interim periods within those financial years.

March 2014

Fair Value Measurement – Questions and Answers – November 2013



Focuses on fair value measurement, providing guidance on the application of the standards and highlighting the handful of differences between US GAAP and IFRS.

November 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

Ireland
Jonathan Lew
T: +353 1 410 1483
E: Jonathan.lew@kpmg.ie

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 58 249 4188
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 Nicholas Murphy.

KPMG International Standards Group is part of KPMG IFRG Limited.

Publication name: *The Bank Statement*

Publication number: Issue 13

Publication date: April 2014

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.