THE
BANK STATEMENT
Q2 2014 NEWSLETTER

cutting through complexity

"Financial institutions expecting to benefit from the flexibility offered by the IFRS 9 general hedging model should be aware of some potential complexities."

Anders Torgander,
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THE NEW APPROACH FOR MACRO HEDGE ACCOUNTING AND SOME COMPLEXITIES OF THE IFRS 9 GENERAL HEDGING MODEL

Welcome to the Q2 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 issued a discussion paper on a **new approach for macro hedging** and the **new standard on revenue recognition** – see page 2.
- The **new general hedging model under IFRS 9**: We discuss new possibilities, challenges and judgements from a practitioner's perspective – see page 5.
- **Section on benchmarks**: We have looked at the financial statements issued by 10 banks reporting under IFRS to compare their **disclosures on CVA and DVA** – see page 10.
- Banks are issuing **contingent convertible capital instruments** (CoCos) to improve their capital ratios. We discuss some of the accounting implications from the perspective of the issuer – see page 12.

Aligning macro hedge accounting with risk management

On 17 April 2014, the IASB published a discussion paper (DP) on a new approach for macro hedge accounting. Like the general hedge accounting model finalised in November 2013, the macro hedge accounting model aims to better reflect companies' risk management activities while reducing operational complexities. The project involves fundamental accounting questions and is not simply a modification of existing hedge accounting models.

To help stimulate debate, the DP puts forward an outline of one possible approach to macro hedge accounting, a 'portfolio revaluation approach' (PRA), which in some ways is similar to the fair value hedge model. Under this approach:

- managed exposures would be identified and remeasured for changes in the managed risk, with the gain or loss recognised in profit or loss. The remeasurement would be based on a present value technique;
- risk management derivatives – i.e. hedging instruments – would continue to be measured at fair value through profit or loss (FVTPL);
- the performance of a company's dynamic risk management activities would be captured by the net effect of the above measurements in profit or loss; and
- risks that are not managed would not be included in this approach – i.e. this is not a full fair value model.

The IASB expects the PRA to be operationally easier to apply than the current hedge accounting models because:

- the accounting result would be consistent with risk management activities; and
- it would not require a specific linkage between managed exposures and risk management derivatives.

Comments on the discussion paper are due by 17 October 2014. The unusually long comment period, of six months, reflects the complexity of this issue, the broad range of risk management practices and the potentially pervasive impact on banks' financial position and performance.

New global framework for revenue

On 28 May 2014, the IASB published a new standard on revenue recognition, IFRS 15 *Revenue from Contracts with Customers*[1], which replaces most of the detailed guidance on revenue recognition that currently exists in IFRS. The standard, which was issued jointly with the FASB, contains a single model that applies to contracts with customers. It has two approaches to recognising revenue: at a point in time and over time.

IFRS 15 does not apply to transactions in the scope of IFRS 9 *Financial Instruments* or IAS 17 *Leases*, but may apply to other elements of a bank's revenue. For example, fees that are not part of effective interest rate calculations will be accounted for under IFRS 15. These fees may include compensation for servicing a loan, certain commitment fees to originate a loan, loan syndication fees or asset management fees. If the fees are variable – e.g. success or performance fees – then judgement will probably be required to determine the amount and timing of revenue to recognise.

Accounting for term-structured repo transactions

In March 2014, the IFRS Interpretations Committee discussed how to apply the guidance in IAS 39 *Financial Instruments: Recognition and Measurement* on linking financial instruments (paragraph IG.B.6) to a term-structured repo transaction. The transaction in the example submitted comprised a purchase and simultaneous sale of a bond and an interest rate swap.

The Committee noted that, to determine whether the entity should aggregate and account for the three transactions as a single derivative, reference should be made to paragraphs IG.B.6 and IG.C.6 of IAS 39 and AG39 of IAS 32 *Financial Instruments: Presentation*. It also noted that

1 For more information, see the IFRS – revenue hot topics page on our website.

the indicators in paragraph IG.B.6 of IAS 39 may help an entity to determine the substance of the transaction, but that the presence or absence of any single specific indicator alone may not be conclusive.

The Committee noted that providing additional guidance would result in attempting to specify the accounting for a specific transaction, and that this would not be appropriate. It therefore decided not to add this issue to its agenda.

Classification of a hybrid financial instrument by the holder

In March 2014, the IFRS Interpretations Committee discussed the classification by the holder of a hybrid financial instrument whose issuer has an option to extend maturity, settle early and/or suspend interest payments. More specifically, the question raised by the submitter was whether the host of the instrument should be classified as equity or debt.

The Committee noted that the financial instrument described in the submission is specific and it would not be appropriate to provide guidance on this particular issue. It also noted that IFRS 9 would resolve the question because it would not require bifurcation for hybrid contracts with financial asset hosts.

As a result, the Committee tentatively decided not to add this issue to its agenda.

IFRS 10 definition of investment-related services or activities

In March 2014, the IFRS Interpretations Committee discussed the definition of 'investment-related services or activities' as it relates to subsidiaries that act as intermediate holding companies ('intermediate subsidiaries') and are established for 'tax optimisation' purposes. Some investment entities establish wholly owned intermediate subsidiaries whose sole purpose is to minimise the tax paid by investors in the parent investment entity. There is no activity within the subsidiary and the tax advantage arises because of returns being channelled through the jurisdiction of the intermediate subsidiary. The submitter asked whether the tax optimisation described should be considered investment-related services or activities.

The Committee noted that the IASB had considered requiring an investment entity to consolidate investment entity subsidiaries that are formed for tax purposes, but had decided against this. One of the characteristics of tax optimisation subsidiaries described in the submission is that there is no activity within the subsidiary. The Committee noted that the parent should not consolidate such subsidiaries, because they do not provide investment-related services or activities, and do not meet the requirements for consolidation under IFRS 10 *Consolidated Financial Statements*. The parent should therefore account for such an intermediate subsidiary at fair value.

The Committee considered that, in the light of the existing IFRS requirements, neither an interpretation nor an amendment to a standard is necessary and consequently decided not to add the issue to its agenda.

IFRIC 21: Identifying a present obligation to pay a levy subject to a threshold

Also in March 2014, the IFRS Interpretations Committee discussed a scenario in which an obligation to pay a levy arises as a result of activity during a period but is not payable until a minimum activity threshold, as specified by the legislation, is reached. The threshold is set on an annual basis, but is reduced if an entity does not participate in the relevant activity for the whole year. The request asked for clarification of how the thresholds should be taken into consideration when identifying 'the activity that triggers the payment of the levy' in paragraph 8 of IFRIC 21 *Levies*.

The Committee noted that in the circumstances described above, the payment of the levy is triggered by the reaching of the annual threshold. The entity would be subject to a threshold that is lower than the annual one if, and only if, it stops the relevant activity before the end of the annual assessment period. Accordingly, the Committee observed that in the light of the guidance in paragraph 12 of IFRIC 21 the obligating event for the levy is the reaching of the annual threshold. The Committee noted that there is a distinction between a levy with an annual threshold that is reduced pro rata when a specified condition is met and a levy for which an obligating event occurs progressively over a period of time, as described in paragraph 11 of IFRIC 21; until the specified condition is met, the pro rata reduction in the threshold does not apply.

The Committee noted that the guidance in IFRIC 21 and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* is sufficient and decided not to add this issue to its agenda.

Accounting by an issuer for a financial instrument mandatorily convertible into a variable number of shares subject to a cap and a floor

In May 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 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.

The Committee noted that the issuer's obligation to deliver a variable number of its own equity instruments is a non-derivative that meets the definition of a financial liability in paragraph 11(b)(i) of IAS 32 in its entirety. That paragraph does not have any limits or thresholds on the degree of variability that is required. Also, a single obligation to deliver a variable number of own equity instruments cannot be subdivided into components for the purpose of evaluating whether the instrument contains a component that meets the definition of equity. The Committee also noted that the cap and the floor are embedded derivative features whose values change in response to the price of the issuer's equity share. Therefore, assuming that the issuer has not elected to designate the entire instrument under the fair value option, the issuer has to separate those features and account for them separately from the host liability contract at FVTPL in accordance with IAS 39 or IFRS 9.

The Committee decided not to add the issue to its agenda.

IFRS 7: Annual improvements

In June 2014, the IASB tentatively decided to finalise the improvements proposed in the exposure draft ED/2013/11 *Annual Improvements to IFRSs 2012–2014 Cycle* (ED), published in December 2013, with the adjustments discussed below. The effective date has been tentatively set as 1 January 2016.

Servicing contracts

The amendment proposed in the ED would clarify how an entity should apply the guidance in paragraph 42C of IFRS 7 *Financial Instruments: Disclosures* to determine if a servicing contract is a 'continuing involvement' for the purposes of the disclosure requirements in IFRS 7. The IASB tentatively decided to finalise the proposed amendment, with the following changes:

- the amendment should not include the presumption that the right to earn a fee for servicing is generally a continuing involvement; and
- the amendment should clarify that the term 'continuing involvement' in IFRS 7 is defined differently from IAS 39 and IFRS 9.

Applicability of the offsetting disclosures in IFRS 7 to condensed interim financial statements

The amendment proposed in the ED would clarify that the additional disclosure required by *Disclosures – Offsetting Financial Assets and Financial Liabilities (Amendments to IFRS 7)* is not specifically required in condensed interim financial statements that are prepared in accordance with IAS 34 *Interim Financial Reporting* for all interim periods. However, the additional disclosure is given when its inclusion would be required in accordance with the general principles of IAS 34.

A PRACTITIONER'S PERSPECTIVE ON NEW HEDGING POSSIBILITIES, CHALLENGES AND JUDGEMENTS

> "IFRS 9 does not fundamentally change the types of hedging relationships or the requirement to measure and recognise ineffectiveness; however, more hedging strategies will qualify for hedge accounting."

Editorial by Anders Torgander, Accounting Advisory Services, KPMG in Sweden

The hedge accounting requirements under IAS 39 have long been criticised for being too complex and rules-based, and for making it difficult for users to understand the information in the accounts. The amended general hedging model[2] tries to address some of these concerns.

The new standard does not fundamentally change the types of hedging relationships or the requirement to measure and recognise ineffectiveness; however, under the new standard more hedging strategies that are used for risk management will qualify for hedge accounting. Some of the key changes introduced include:

- the retrospective testing of effectiveness and the arbitrary 80–125 percent threshold are removed;
- hedge accounting is available for a broader range of hedging strategies; and
- voluntary termination of hedging relationships that continue to meet the risk management objective and all other qualifying criteria is not allowed, although rebalancing may be required.

Some banks may believe that the new standard will not significantly change the status quo, because they expect more impact from the macro hedging project, for which a discussion paper was released in April 2014[3]. Others may see an immediate effect on how they are able to reflect their risk management strategies in the financial statements. However, financial institutions should be aware of some potential complexities, such as:

- the application guidance remains complex in some areas;
- more judgement will be required to assess the effectiveness of a hedging relationship;
- the hedging relationship will still have to be carefully documented; and
- extensive new disclosures will be necessary to better explain the increased level of judgement inherent in the new model.

Qualifying criteria

Many of the concepts used in IAS 39 are retained under IFRS 9, including:

- the three types of hedging relationships – i.e. fair value hedge, cash flow hedge and hedge of a net investment in a foreign operation; and
- many of the key definitions – i.e. hedged items, hedging instruments, hedge effectiveness – and the qualifying criteria for hedge accounting.

Formal designation and documentation

IFRS 9 continues to require formal designation and documentation of the hedging relationship at inception of the hedging relationship. Also, although the content of the documentation is broadly similar to IAS 39, changes may be necessary.

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2 IFRS 9 *Financial Instruments* (2013), issued in November 2013.
3 See our In the Headlines: Accounting for dynamic risk management activities, May 2014.

Hedging instruments and hedged items

Increased flexibility

IFRS 9 introduces greater flexibility and better alignment with internal risk management, because it allows:

- more instruments to qualify as hedging instruments:
  - for example, certain non-derivative instruments measured at FVTPL; and
  - a combination of written and purchased options as long as the hedging instrument is not a net-written option;
- more exposures to be designated as hedged items – e.g. aggregated positions in which a derivative together with a cash instrument form an eligible hedged item;
- designation of certain credit exposures as at FVTPL as a substitute for hedge accounting; and
- recognition in other comprehensive income (OCI) of fluctuations in the fair value of certain portions of a hedging instrument excluded from a hedging relationship – e.g. changes in fair values of currency basis swaps that relate to changes in the currency basis spread.

Example 1 – Aggregate positions

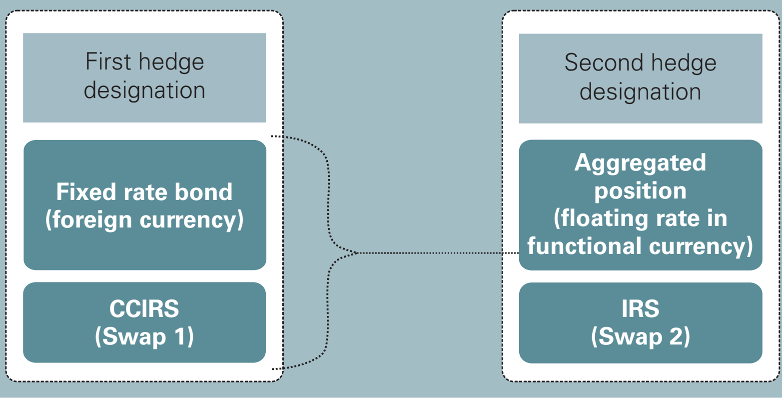
Entity E holds a 10-year fixed-rate debt denominated in a foreign currency. Under its internal risk management, E hedges the following:

- the foreign currency risk for the entire term of the debt; and
- the interest rate risk for the following two years, on a rolling basis.

E uses the following hedging instruments for its internal risk management purposes:

- a 10-year fixed-to-floating cross-currency interest rate swap (CCIRS), the effect of which is to swap the fixed-rate foreign currency debt into a variable-rate functional currency exposure (Swap 1); and
- a two-year interest rate swap (IRS), the effect of which is to swap variable-rate debt (due to Swap 1) into fixed-rate debt (on a rolling basis) (Swap 2).

Under IFRS 9, E may designate the aggregate position of the debt and Swap 1 as a hedged item.



Using the fair value option as a substitute for hedge accounting

Banks may have designated certain financial instruments as at FVTPL under IAS 39 as a substitute for hedge accounting. Although this designation is simpler than applying hedge accounting, one of its drawbacks is that it is irrevocable and therefore changes in risk management cannot be reflected in the financial statements. This has sometimes led to significant volatility in profit or loss. The adoption of IFRS 9 offers banks an opportunity to revoke fair value options that are no longer required.

In some cases, the adoption of IFRS 9 may reduce volatility caused by the use of a fair value option. For example, this would be the case where an entity has designated a liability at FVTPL to eliminate or significantly reduce a measurement inconsistency. If under IFRS 9 changes in the liability's credit risk are presented in OCI, then volatility in profit or loss is likely to reduce. However, the option to designate at FVTPL may be operationally complex for some complex structured products.

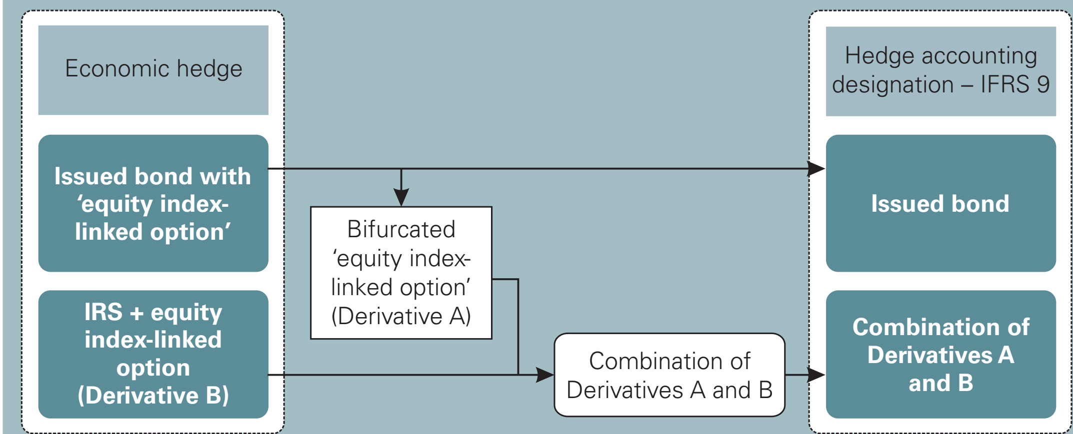
Also, under IFRS 9 a bank will be able to use a more flexible designation as at FVTPL in circumstances where it uses a credit derivative that is measured at FVTPL to manage the credit risk of an exposure. In such cases, the bank can designate the credit exposure as at FVTPL. This designation can be made at initial recognition of the credit exposure or subsequently.

Example 2 – Combination of written and purchased options

Banks issuing structured bonds often hedge the resulting market risk exposure.

For example, assume that a bank issues a fixed-term bond with an embedded feature that gives an investor exposure to a market equity index. The feature has a floor so that the investor is not exposed to the downside risk of the equity index but can benefit from the upside. In effect, the embedded derivative (Derivative A) is a written option on that equity index. For risk management purposes, the bank hedges this risk as well as the fair value interest rate risk of the structured bond with an interest rate swap that includes a purchased option (Derivative B) in the receive leg for the equity index risk.

Under IAS 39, the fair value option is often selected for such structured bonds as a substitute for hedge accounting. This is because, if the structured bond is not accounted for as at FVTPL, then the embedded feature – i.e. the written option – requires bifurcation and accounting for as at FVTPL because it is not closely related to the host instrument. Under IAS 39, it is not possible to designate the bifurcated Derivative A in combination with Derivative B as a hedging instrument, because IAS 39 precludes the designation of a combination of separate derivatives as a hedging instrument if one of those instruments is a written option. However, IFRS 9 allows a stand-alone written option to be jointly designated with other instruments as long as in combination they do not result in a net written option. In this example, the written and purchased option have matching terms and in combination do not result in a net written option.



Excluding components of the hedging derivative from the hedging relationship

As under IAS 39, banks may choose to exclude certain components of the hedging derivative from the hedging relationship (i.e. the time value of purchased options, the forward element of forward contracts and, additionally under IFRS 9, foreign currency basis spreads) and designate only the remaining portion of its fair value (e.g. the intrinsic value of an option) as the hedging instrument. However, banks wishing to exclude these components from the hedging relationship (and recognise them in OCI) are likely to find that the process and the resulting accounting are more complex than under IAS 39.

Unlike under IAS 39, how the excluded element is recognised in profit or loss depends on the type of hedging instrument and the choice made by a bank, as follows.

- If the excluded element is the time value of an option, then it is recognised in OCI (subject to certain limits).
- If the excluded element is the forward element of a forward contract or foreign currency basis spread of a financial instrument, then the bank can choose whether to recognise it in OCI (subject to certain limits).

The IASB acknowledged that the requirement in IAS 39 to recognise in profit or loss the fluctuations in fair value of the element excluded from the hedging relationship created a disconnect between the accounting treatment and the risk management view, because entities typically consider the time value of an option at inception of a contract (the premium paid) as a cost of hedging akin to a cost of buying insurance protection. Accordingly, IFRS 9 allows or requires those fluctuations in fair value to be recognised in OCI.

Subsequent recognition in profit or loss of amounts initially recognised in OCI

Once a bank determines the amount to be recognised in OCI in respect of the excluded elements of options, forward contracts and other financial instruments, it will then have to determine how the amounts recognised in OCI should subsequently be recognised in profit or loss. This depends on whether the hedged item is transaction related or time-period related and so will require further analysis.

Change of critical terms of the hedged item

The accounting for the excluded portion of a hedging instrument applies only to the extent that the excluded portion relates to the hedged item. This is referred to as the 'aligned' portion – e.g. the aligned time value. Additional complexities may arise if the critical terms of the hedged item change during the course of the hedging relationship – e.g. the expected timing of a forecast transaction may change – and the change does not result in the discontinuation of hedge accounting. In this situation, it appears that the bank should:

- recalculate the aligned excluded amount as at the inception of the hedging relationship based on the revised critical terms of the hedged item; and
- determine the cumulative change in the fair value of the recalculated aligned excluded amount from inception to determine the amount that is accumulated in a separate component of equity.

Hedge effectiveness

IFRS 9 defines the objective of hedge accounting as "to represent, in the financial statements, the effect of an entity's risk management activities that use financial instruments to manage exposures". Consequently, subject to qualifying criteria, the model in IFRS 9 uses the risk management activities of an entity as the foundation for deciding what qualifies for hedge accounting. The aim of the model is to faithfully represent, in the financial statements, the impact of the risk management activities of an entity.

This approach impacts the manner in which hedge effectiveness is assessed.

IFRS 9 removes the requirement for retrospective testing of effectiveness. It also removes the arbitrary 80–125 percent threshold for assessing effectiveness, recognising that in practice an entity may be willing to enter into (or continue with) a hedge that falls outside this range because the hedge is considered to be economically effective and there may be no better alternative. For example, when IFRS 13 *Fair Value Measurement* became effective, some banks that did not reflect own non-performance risk in the valuation of hedging derivatives under IAS 39 terminated the related hedging relationships because, as a result of inclusion of the debit valuation adjustment (DVA) in the hedging instrument but not in the hedged item, the hedging relationship no longer met the 80–125 percent threshold. This may also be true for other types of adjustments made in the valuation of portfolios of derivatives that are used as hedging instruments, such as credit valuation adjustment (CVA), bid-ask spread or funding valuation adjustment.

However, IFRS 9 has an explicit requirement that hedge accounting be more closely aligned with an entity's actual risk management objectives. This principle is reflected in the effectiveness requirements of the standard, which require that:

- there is an economic relationship between the hedged item and the hedging instrument;
- the effect of credit risk does not dominate the value changes that result from the economic relationship;
- the hedge ratio is the same as that which the entity uses; and
- the hedged item and the hedging instrument are not intentionally weighted to create hedge ineffectiveness to achieve an accounting outcome that would be inconsistent with the purpose of hedge accounting.

Banks will therefore need to update their hedging documentation and assess whether old designations under IAS 39 are in line with their risk management objectives, and also update their processes to include these additional requirements of effectiveness assessment on an ongoing basis. Hedge designations that are driven only by accounting considerations would not meet the new requirements. However, judgement will be required to assess how close the alignment is between the risk management and accounting designation and whether it is sufficient to meet the IFRS 9 requirements.

This process could, in turn, cause an entity to amend its current risk management policies or create new ones. It could lead to hedge accounting being applied to different types of hedges or being applied in different ways from before.

Disclosures

The disclosure requirements under IFRS 9 are more extensive than those under IAS 39, as a consequence of the increased level of judgement inherent in the new model. The disclosures have been designed to address financial statement users' complaints that disclosures on hedge accounting were not transparent or helpful.

Some of the additional disclosure requirements include (to name just a few):

- explanation of a bank's risk management strategy for each category of risk exposure that a bank decides to hedge and for which hedge accounting is applied. This includes information on how a bank determines the economic relationship between the hedged item and the hedging instrument;
- quantitative information to allow users to evaluate the terms and conditions of hedging instruments;
- the sources of hedge ineffectiveness, by risk category; and
- quantitative data in a tabular format.

Banks should not underestimate the amount of effort that will be required to gather the required information, both at transition to IFRS 9 and on an ongoing basis.

HOW DO YOU COMPARE? CVA/DVA DISCLOSURES

Inclusion of both CVA and DVA in derivatives valuation has become a normal business practice.

Determining the fair value of over-the-counter (OTC) derivative contracts has evolved in recent years. On top of this, the implementation of IFRS 13 (effective from 1 January 2013) has meant that including both CVA and DVA in derivative valuations has become a normal business practice. We looked at 10 financial statements issued by banks reporting under IFRS to compare their disclosures on CVA and DVA.[4]

What are the IFRS 13 requirements?

IFRS 13 does not contain specific requirements on disclosing information about CVA and DVA. Therefore, the extent of disclosure depends on a bank's judgement, in the context of:

- its business; and
- what information should be disclosed to meet:
  - the overall disclosure objective of IFRS 13; and
  - other specific disclosure requirements of IFRS 13 – e.g. relating to unobservable inputs.

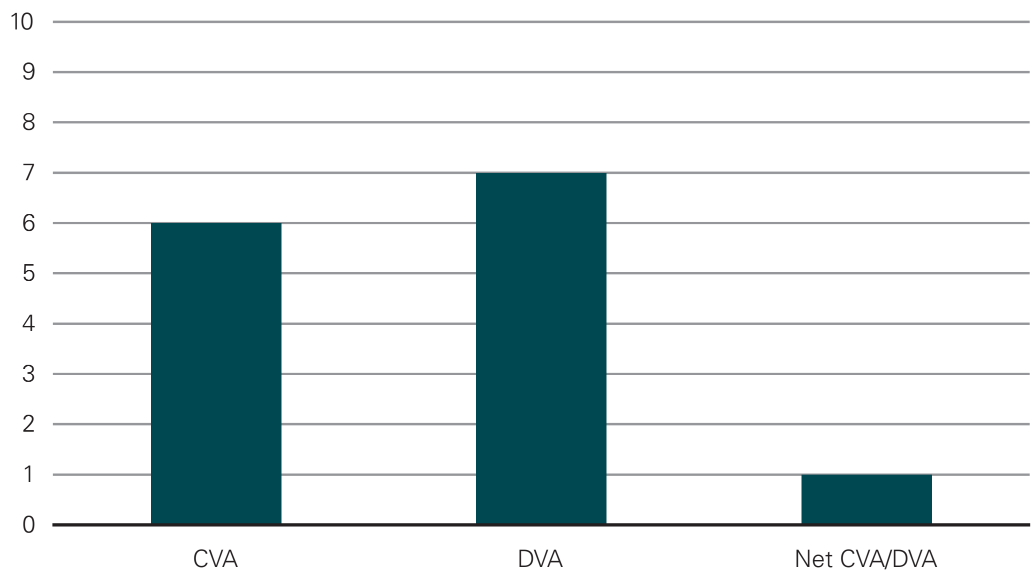
The general disclosure objective of IFRS 13 for assets and liabilities measured at fair value is to help users of the financial statements to assess:

- the valuation techniques and inputs used to develop fair value measurements; and
- for fair value measurement using significant unobservable inputs, the effect of the measurements on profit or loss or OCI.

How many banks disclosed the amounts of CVA or DVA?

The majority of the banks in our sample disclosed the amounts of their CVA and DVA (see chart), usually by providing separate figures for each, with one bank disclosing the net effect. The remaining banks provided narrative disclosures, with some stating that the effect of CVA/DVA adjustments was not significant.

Number of banks that disclosed the amount of CVA/DVA



4 The financial statements were for the year ended 31 December 2013.

What other information did banks disclose?

Impact of CVA on level in the fair value hierarchy

One bank reported that the inclusion of CVA led to the classification of part of its derivative portfolio as Level 3. This was due to the significance of unobservable credit spreads used in calculating the adjustment. The bank disclosed the range of unobservable credit spreads used in the valuation.

Valuation techniques

Banks disclosing the amounts of CVA and DVA usually also disclosed the methodology used for the calculation. Generally, their calculations were performed on a counterparty-by-counterparty basis and were derived from estimates of:

- exposure at default;
- probability of default; and
- recovery rates/loss given default.

A number of banks used simulation techniques to calculate exposure at default. Some set exposure to zero if strong collateralisation agreements were in place, whereas others included credit mitigating factors such as netting and collateral arrangements in the simulation methodology. One bank stated explicitly that it used the same exposures as those used for regulatory purposes.

Probability of default and recovery rates were often sourced from credit default swap (CDS) markets. When CDS markets were not available, alternative approaches included using historical information and internal ratings. Some banks also used information from primary and secondary bond markets. One bank made specific disclosures of the actual rates used – one rate for developed markets and one for emerging markets exposures.

Financial instruments subject to CVA/DVA adjustment

Banks did not generally calculate CVA and DVA on the whole OTC derivative portfolio. Some disclosed which exposures they had scoped out, which included:

- exposures with central clearing counterparties;
- exposures with counterparties subject to standard interbank collateral agreements (see above about valuation techniques); and
- collateralised overnight index swaps.

REGULATION IN ACTION: COCO SECURITIES – ARE THEY EQUITY OR LIABILITIES?

The requirements in IAS 32 relating to equity/liability classification by the issuer are complex and require detailed analysis of all contractual terms of the instrument.

What are CoCo securities?

In the wake of the financial crisis, a number of initiatives were developed to make banks safer. As a result, banks have begun to issue hybrid capital securities that absorb losses when the bank's capital falls below a certain level or another specified non-viability event occurs. These securities are commonly referred to as 'contingent convertible capital instruments' (CoCos). This term is often used to describe both instruments that convert into common equity shares and those that are written down when a non-viability event occurs, even though the latter do not convert into new instruments.

Under Basel III, CoCos could qualify[5] as either additional Tier 1 or Tier 2 capital, depending on their terms. National regulators have discretion in specifying particular terms and conditions.

Key features of CoCos that tend to differ are the loss-absorption mechanism and the trigger that activates that mechanism. The loss-absorption mechanism is generally in the form of conversion into equity or writing down the entire amount of the outstanding bonds. The trigger is usually either mechanical (i.e. defined numerically in terms of a specific capital ratio) or discretionary (i.e. subject to supervisory judgement). The table below provides a high-level summary of some of the attributes of CoCos.

Maturity	Perpetual.	Specified maturity (not eligible for additional Tier 1 capital).
Trigger	Mechanical (e.g. Basel III Common Equity Tier 1 ratio falling below 5.125%).	Discretionary (based on supervisory judgement).
Loss-absorption mechanism	Equity conversion – the following conversion ratios are frequently used: i. market price of the stock; ii. pre-specified price; and iii. a combination of (i) and (ii).	Write-down: i. permanent/temporary; and ii. full/partial.
Examples of other features	Issuer's call option (usually only after five years to qualify for regulatory capital).	Discretionary interest/ dividend payments.

Debt or equity?

A key accounting question for the issuer of a CoCo is whether the security is classified as equity, a financial liability or a combination of both – i.e. a compound instrument. In addition, the conversion feature may be an embedded derivative that requires separate accounting. Depending on this analysis, further difficult questions may arise over how to measure the security or its components.

Under IFRS, an instrument, or its components, is classified on initial recognition as a financial liability, a financial asset or an equity instrument in accordance with the substance of the contractual arrangement and the definitions of a financial liability, a financial asset and an equity instrument. For example, an instrument is classified as a financial liability if it is:

- a contractual obligation to deliver cash;
- a non-derivative contract that comprises an obligation for the issuer to deliver a variable number of its own equity instruments; or

5 *Bank for International Settlements Quarterly Review*, September 2013.

- a derivative contract that will or may be settled other than by the issuer exchanging a fixed amount of cash for a fixed number of its own equity instruments.

An instrument may contain a contractual obligation for the issuer to deliver cash (or a variable number of its own equity instruments) depending on the outcome of an uncertain future event that is beyond the control of both the issuer and the holder of the instrument – e.g. changes in the issuer's debt-to-equity ratio. When an instrument contains a contingent settlement provision like this, the issuer does not have the unconditional right to avoid making payments. Therefore, the instrument is a financial liability, unless the condition is not genuine or occurs only in the event of the issuer's liquidation.

An analysis of all features of a CoCo taken together will be necessary to apply the full requirements of IFRS to a bank's particular facts and circumstances. IAS 32 is the principal source of guidance on equity/liability classification. Its provisions are complex and require detailed analysis of all contractual terms of the instrument. The application of IAS 32, including to certain CoCos, has been discussed several times by the IFRS Interpretations Committee – for a summary of the most recent discussions, see pages 2–4.

Two examples of applying IAS 32 are illustrated below.

Example 1 – Security S convertible to equity on occurrence of 'non-viability' event

Issuer:	Bank X
Currency:	Functional currency of X
Maturity period:	10 years
Coupon:	8% fixed interest per annum paid semi-annually
Premium/discount:	Not material
Trigger:	Common equity Tier 1 ratio of X falls below 7.25%
Loss-absorption mechanism:	On occurrence of a non-viability event of X, Security S converts into a fixed number of equity shares of X

Security S includes a contractual obligation of Bank X to deliver cash, because:

- the payment of interest and principal on Security S is mandatory, except when a non-viability event occurs and so X has a contractual obligation to deliver cash; and
- the occurrence or non-occurrence of a non-viability event is outside the control of both X and the holder of Security S.

In addition, X considers that Security S also includes an equity component because, on occurrence of a non-viability event, Security S is converted into a fixed number of equity shares of X. The fact that a non-viability event may not occur and therefore X may have to repay the full principal amount at maturity and pay all interest does not in itself preclude equity classification of the conversion feature. This is because the only way that settlement of the feature could take place is by delivering a fixed amount of shares in exchange for a fixed principal amount of Security S.

Accordingly, X concludes that Security S qualifies as a compound instrument that contains both equity and liability components.

Example 2 – Security T written off on occurrence of 'non-viability' event

Issuer:	Bank Y
Currency:	Functional currency of Y
Maturity period:	10 years
Coupon:	8% fixed interest per annum paid semi-annually
Premium/discount:	Not material
Trigger:	Common equity Tier 1 ratio of Y falls below 7.25%
Loss-absorption mechanism:	On occurrence of a non-viability event of Y, Security T is fully written off – all future coupon and principal obligations will be extinguished

Similarly to Example 1, and for the same reasons, Security T includes a contractual obligation of Bank Y.

However, unlike Example 1, Security T does not have a conversion feature, but instead the whole amount is written off on the occurrence of a non-viability event. Therefore, as a next step Y assesses whether the non-viability feature is a derivative that should be accounted for separately at FVTPL.

An embedded feature has to be separated from a host contract if it meets all of the following conditions:

- it is a separate feature with terms that meet the definition of a derivative in IAS 39;
- the economic characteristics of the embedded derivative are not closely related to the host contract; and
- the whole contract is not accounted for at FVTPL.

On the assumption that Security T is not accounted for at FVTPL, the last two conditions are met. However, Y also assess whether the embedded feature meets the definition of a derivative.

IAS 39 excludes from the definition of a derivative an instrument whose underlying is a non-financial variable specific to a party to the contract. In our view, this exclusion is intended primarily to exclude insurance contracts. However, in our view, other variables such as profit, revenue or cash flows of a party to the contract may be considered to be subject to the exclusion and an entity should choose an accounting policy, to be applied consistently, in this regard.

Depending on Y's accounting policy, Y accounts for Security T as:

- a non-derivative host liability with the embedded non-viability feature separately accounted for as a derivative; or
- a non-derivative liability without the non-viability feature separated.

The terms of CoCos and the associated accounting analyses can be even more complex than illustrated above, including if the conversion ratio into equity shares is variable, or the issuer has discretion to avoid payment of principal and/or interest. The underlying complexities can be illustrated by a submission to the IFRS Interpretations Committee in which the submitter included five different views on the accounting analysis (refer to the Committee meeting in July 2013).

ECB reduces key interest rate to below zero

The European Central Bank (ECB) has cut its main refinancing rate to 0.15 percent and its deposit rate from zero to -0.1 percent.

Negative interest rates raise a question of how the resulting negative interest should be presented in the income statement.

There is no explicit guidance in IFRS on the presentation of negative interest. However, the IFRS Interpretations Committee discussed the issue in September 2012 and January 2013. In September 2012, the Committee noted as part of its tentative agenda decision that interest resulting from a negative effective interest rate on a financial asset:

- does not meet the definition of interest revenue in IAS 18 *Revenue* because it reflects a gross outflow, instead of a gross inflow, of economic benefits; and
- is not an interest expense because it arises on a financial asset instead of on a financial liability of the entity.

Consequently, at that time the Committee considered that expense arising on a financial asset because of a negative effective interest rate should not be presented as interest revenue or interest expense, but in some other appropriate expense classification. However, in its January 2013 meeting the Committee decided not to finalise its tentative agenda decision until the IASB had completed its redeliberations on the exposure draft ED/2012/4 *Classification and Measurement (Limited Amendments to IFRS 9),* to avoid unintended consequences for the classification of financial assets in accordance with IFRS 9.

Accordingly, for now, banks affected by negative interest rates will have to use judgement to determine an appropriate presentation of the expense in their financial statements. In addition, under paragraphs 85 and 112(c) of IAS 1 *Presentation of Financial Statements*, it may be necessary to present additional information about negative interest income if it is relevant to an understanding of the entity's financial performance or to an understanding of this item.

EBA shapes leverage ratio disclosures

On 5 June 2014, the European Banking Authority (EBA) issued the final draft of its *Implementing Technical Standards* (final draft ITS) on disclosure of the leverage ratio (EBA/ITS/2014/04). The EBA notes that the final draft ITS has been aligned as much as possible with the Basel III disclosure requirements published on 12 January 2014 by the Basel Committee on Banking Supervision (BCBS) (see the Q1 2014 issue of *The Bank Statement*). However, the EBA has expanded the disclosures by requiring further breakdown of the leverage ratio.

The final draft ITS does not prescribe the frequency or the start date for the disclosures. These requirements are included in Articles 521(1) and 433 of the *Capital Requirements Regulation*, which state that the disclosures:

- apply from 1 January 2015; and
- are to be published at least on an annual basis, with annual disclosures released in conjunction with the date of publication of the financial statements. Entities will also assess the need to publish some or all disclosures more frequently in light of the relevant characteristics of their business.

The EBA has retained the requirement included in the BCBS's January paper to reconcile the accounting assets to the exposures used to calculate the leverage ratio. However, in contrast to the BCBS paper, the final draft ITS does not suggest where the disclosure of the leverage ratio could be made and does not require the financial statements to provide, at a minimum, a direct link to the completed disclosures on a bank's website or in its publicly available regulatory reports.

EBA consults on materiality

On 13 June 2014, the EBA launched a consultation on its draft guidelines on materiality, proprietary information and confidentiality (EBA/CP/2014/09) (the consultation paper). The existing EU regulations allow banks to omit certain disclosures required by regulators if the information provided by the disclosure is not regarded as material or would be regarded as proprietary or confidential. The consultation paper contains proposals on how banks should apply the terms 'materiality', 'proprietary' and 'confidentiality' in relation to the regulatory disclosure requirements.

The EBA notes that the concept of materiality is also defined in IFRS, but it serves different objectives and so may be implemented differently despite the areas of crossover. Therefore, information that is material for the annual report could potentially be immaterial for Pillar 3 regulatory reporting, and vice versa.

IAS 1 includes the following definition of materiality: "Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor."

The consultation paper proposes to include the following requirements in the assessment of materiality.

- Materiality should be assessed at the level of each individual disclosure requirement and, where relevant, on an aggregate basis. In particular, the institution should assess if the cumulative effect of omitting specific disclosure requirements that are regarded individually as not material would result in omission of information that could influence the economic decisions of users.
- Materiality should be a user-centric concept and be assessed according to the assumed users' needs based on the assumed relevance of information for users: a disclosure requirement may not be material for the institution but may be material for users … Information related to items involving a high degree of subjectivity from institutions in determining their amount is likely to be material for users.
- Materiality should be assessed taking into account the specific nature and purpose of the requirement assessed.
- Materiality does not depend only on size.
- Materiality is a dynamic concept: materiality depends on the context of disclosures and may therefore be applied differently to different disclosures over time depending on the evolution of risk.

The proposed guidance is more detailed than that in IFRS. However, the underlying concepts are very similar. Because the concepts apply to two different disclosure requirements – i.e. the IFRS definition applies to financial reporting, whereas the proposed EBA definition would apply to regulatory reporting under Pillar 3 – in many instances, the judgement of whether something is material would be applied to different information. However, to the extent that disclosure overlaps, banks would have to consider how they define materiality for both purposes and whether a different outcome for any specific requirement is appropriate.

The consultation period ends on 13 September 2014 and the EBA aims to finalise the guidance by 31 December 2014.

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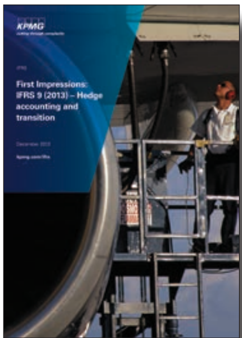

Considers the requirements of the new general hedge accounting model in IFRS 9 *Financial Instruments* (2013).

December 2013

Aligning bank reporting with shareholder value

Discusses how banks' financial reports can be transformed from tables of data into documents that better support an analysis of shareholder value.

April 2014

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