THE BANK STATEMENT

Q1 2015 NEWSLETTER

KPMG
cutting through complexity

"The goal of consistent interpretation of the impairment requirements of IFRS 9 across different entities would benefit from stakeholders working together."

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BASEL COMMITTEE PUBLISHES ITS PERSPECTIVE ON IFRS 9 IMPAIRMENT, AND CLARIFIES LEVERAGE RATIO

Welcome to the Q1 2015 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

- **Spotlight on IFRS 9:** New section focusing on the implementation of IFRS 9 *Financial Instruments* – see page 2.
- We discuss the proposed new guidance on accounting for **expected credit losses** issued by the Basel Committee on Banking Supervision in February, and the proposals' interaction with IFRS 9 – see page 7.
- **How do you compare?** We look at disclosures of **funding valuation adjustments** – see page 10.
- **Regulation in action:** Entities will now mandatorily disclose their **leverage ratio.** To what extent is this exposure measure different from the total assets published in financial statements? See page 12.

SPOTLIGHT ON IFRS 9

Basel Committee issues guidance on accounting for expected credit losses

In response to the recent global shift towards using expected credit loss accounting models, the Basel Committee on Banking Supervision has issued proposals for supervisory requirements on sound credit risk practices associated with the implementation and ongoing application of expected credit loss accounting models.

The proposals contain 11 fundamental principles for sound credit risk practices that interact with expected credit loss measurement. They also include guidance specific to jurisdictions applying IFRS, and relating to the new expected credit loss model in IFRS 9 *Financial Instruments*, issued in July 2014.

We discuss some aspects of the proposals on page 7.

Second Impairment Transition Group meeting

The IFRS Transition Resource Group for Impairment of Financial Instruments (ITG) met on 22 April 2015 to discuss the following issues. Our *IFRS Newsletter: IFRS 9 impairment* will be out soon, summarising the discussions.

- The maximum period to consider when measuring expected credit losses.
- Forecasts of future economic conditions.
- Loan commitments – scope.
- Revolving credit facilities.
- Assessment of significant increase in credit risk for guaranteed debt instruments.
- Measurement of expected credit losses for an issued financial guarantee contract.
- Expected credit losses – measurement date.
- Measurement of expected credit losses in respect of a modified financial asset.

FSB roundtable

The Financial Stability Board (FSB) has announced plans to hold a roundtable in 2015 for standard setters, supervisors and regulators, and other stakeholders to discuss how to further promote consistency of implementation of the accounting standards for financial instruments.

Insights Volume 3

KPMG has published a new third volume of *Insights into IFRS* dedicated to IFRS 9. Find out more on our website.

Measuring investees at FVTPL: An investment-by-investment choice or a consistent policy choice?

IAS 28 *Investments in Associates and Joint Ventures* permits an investment in an associate or a joint venture – held by an investor that is not an investment entity but is a venture capital organisation or other qualifying entity – to be measured at fair value through profit or loss (FVTPL).

In November 2014, the IFRS Interpretations Committee discussed whether this election is available on an investment-by-investment basis, or has to be applied consistently to the measurement of all associates and joint ventures (see the Q4 2014 issue of *The Bank Statement*).

The IASB has since noted that it had intended in its revisions to IAS 28 in 2011 to carry forward unchanged the measurement choice that had been available in the previous version of the standard. It therefore tentatively decided to clarify that the election is available on an investment-by-investment basis.

Additionally, the IASB noted that an investor that is not an investment entity may have an associate or joint venture that is an investment entity, and can choose to retain the fair value measurements used by that investment entity associate or joint venture when applying the equity method. The IASB decided to clarify that this choice is also available on an investment-by-investment basis.

The IASB will propose these amendments as part of the annual improvements process.

Assessment of significant influence: Fund manager acting as agent and holding own investment in the fund

In January 2015, the IFRS Interpretations Committee discussed what factors may indicate that a fund manager has significant influence over a fund that it manages and in which it has a direct holding. The submitter described a particular situation in which an assessment of control under IFRS 10 *Consolidated Financial Statements* resulted in the conclusion that the fund manager does not control the fund that it manages and in which it has a direct holding, because it is acting as an agent in accordance with paragraphs B58–B72 of IFRS 10. The submitter raised two questions in respect of this particular situation:

- whether the fund manager should assess whether it has significant influence over the fund; and
- if yes, how it should make such an assessment.

The Committee noted that a fund manager that concludes that it is an agent in accordance with IFRS 10 should assess whether it has significant influence in accordance with the guidance in IAS 28. In particular, it should consider:

- its holding in the fund; and
- whether its power to participate in financial and operating policy decisions, combined with its holding in the fund, constitute significant influence.

Committee members noted that IFRS 10 did not make any consequential amendments to IAS 28 in relation to the assessment of significant influence. However, the members did not reach agreement on whether and how a power to participate in financial and operating policy decisions that is held in the capacity of an agent should affect the assessment of significant influence.

The IASB currently has a research project on the subject of equity accounting, but it is not clear at this stage whether the assessment of significant influence will form part of that project. Consequently, the Committee decided to monitor how that research project progresses, and to revisit this issue if the research project does not address it.

Classifying the liability for prepaid cards issued by a bank in the bank's financial statements

The IFRS Interpretations Committee received a request to clarify the classification of the liability for prepaid cards issued by a bank in the bank's financial statements and accounting for the unspent balance of prepaid cards with the following contractual features:

- has no expiry date;
- cannot be refunded, redeemed or exchanged for cash;
- is redeemable for goods or services only;
- is redeemable only with selected merchants, which, depending on the card programme, range from a single merchant to all merchants that accept a specific card network; and
- has no back-end fees, which means that the balance on the prepaid card does not reduce unless it is spent by the holder.

The Committee was asked to consider whether the liability for these prepaid cards is a non-financial liability because the issuing bank does not have an obligation to deliver cash to the cardholder.

In November 2014, the Committee observed that the liability for prepaid cards with the features outlined above would meet the definition of a financial liability, because the issuing bank has a contractual obligation to deliver cash to the merchant that is conditional on the cardholder using the prepaid card to purchase goods or services. In that case, an issuing bank would apply the guidance in IFRS 9 (IAS 39 *Financial Instruments: Recognition and Measurement*) to determine when to derecognise the liability for the prepaid card. However, the Committee was concerned about other similar arrangements, such as customer loyalty programmes and prepaid cards issued by a non-banking entity that can be redeemed for goods or services of the issuing entity or of other entities, and asked the staff to analyse those other similar arrangements.

The staff will present a paper to the Committee's next meeting in May.

Fair value hierarchy when third party consensus prices are used

The IFRS Interpretations Committee received a request to clarify under what circumstances prices that are provided by third parties would qualify as Level 1 in the fair value hierarchy in accordance with IFRS 13 *Fair Value Measurement*.

The Committee noted that the fair value hierarchy prioritises the *inputs* to valuation techniques, not the valuation techniques used to measure fair value. Only unadjusted quoted prices in active markets for identical assets or liabilities that the entity can access at the measurement date qualify as Level 1 inputs. Consequently, a fair value measurement that is based on prices provided by third parties may be categorised within Level 1 only if the measurement relies solely on unadjusted quoted prices in an active market for an identical instrument that the entity can access at the measurement date.

On the basis of the above analysis, the Committee determined that neither an interpretation nor an amendment to a standard is necessary. Consequently, it decided not to add this issue to its agenda.

Income and expenses arising on financial instruments with a negative yield: Presentation in the statement of comprehensive income

The IFRS Interpretations Committee discussed the ramifications of the economic phenomenon of negative effective interest rates for the presentation of income and expenses in the statement of comprehensive income.

The Committee noted 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. Consequently, the expense arising on a financial asset because of a negative effective interest rate should not be presented as interest revenue, but in an appropriate expense classification. The Committee noted that in accordance with paragraphs 85 and 112(c) of IAS 1 *Presentation of Financial Statements*, an entity is required to present additional information about such an amount if it is relevant to an understanding of the entity's financial performance or an understanding of this item.

The Committee considered that in light of existing IFRS requirements, an interpretation is not necessary and consequently decided not to add this issue to its agenda.

Accounting for embedded foreign currency derivatives in host contracts

The IFRS Interpretations Committee was asked to consider whether an embedded foreign currency derivative in a licence agreement is closely related to the economic characteristics of the host contract, on the basis that the currency in which the licence agreement is denominated is the currency in which commercial transactions in that type of licence agreement are routinely denominated around the world – i.e. the 'routinely denominated' criterion in paragraph AG33(d)(ii) of IAS 39.

The Committee noted that the issue related to a contract for a specific type of item and observed that an assessment of the routinely denominated criterion is based on evidence of whether such commercial transactions are denominated in that currency all around the world and not merely in one local area. It further observed that the assessment of the routinely denominated criterion is a question of fact and is based on an assessment of available evidence.

On the basis of the above analysis and existing IFRS requirements, the Committee determined that sufficient guidance exists and that neither an interpretation nor an amendment to a standard is necessary. Consequently, the Committee decided not to add this issue to its agenda.

IFRS 15: Endorsement for use in the EU

The European Financial Reporting Advisory Group (EFRAG) has submitted its endorsement advice relating to IFRS 15 *Revenue from Contracts with Customers* for use in the EU and European Economic Area. EFRAG concludes that IFRS 15 meets all technical endorsement criteria of the *IAS Regulation* and is conducive to the European public good. It therefore recommends the endorsement of IFRS 15. EFRAG's recommendation is explained in its letter to the European Commission and the accompanying appendices.

Other projects

Macro hedging: Preparing for the next phase of the project

At its March meeting, the IASB completed its analysis of the feedback received on its April 2014 discussion paper on macro hedging.

Detailed areas covered included revaluing managed exposures, presentation and disclosures, and applying the portfolio revaluation approach to other risks.

Board members also expressed a range of 'bigger picture' views, and seemed to agree that the direction of the project would need to be decided before undertaking section-by-section redeliberations. We expect the overall direction to be determined in future Board meetings.

Insurance contracts

With discussions on participating contracts still continuing, the forthcoming insurance contracts standard will not be published before late 2015 at the earliest.

Because the IASB plans to allow approximately three years between publishing the final standard and having it come into effect, the earliest possible mandatory effective date will now be later than that for IFRS 9 (which is 1 January 2018).

Leases

In a move that signals their determination to proceed with different lease accounting models, the IASB and the FASB have opted to prepare non-converged ballot drafts of their new standards on lease accounting.

In their latest project meetings, the Boards also decided to retain the key elements of their proposed definition of a lease. This will disappoint constituents who were keen to explore alternative approaches.

The Boards have also agreed additional reliefs, including the details of an exemption for 'small-ticket' leases under IFRS and a new transition relief related to the definition of a lease.

The most important outstanding decision is the effective date. The Boards expect to issue their respective new standards by the end of 2015.

KPMG issues newsletters about these projects, among others. For further details, see page 20.

IFRS 9 IMPAIRMENT – BASEL COMMITTEE'S PERSPECTIVE

"Consistent interpretation of the impairment requirements may not result in outcomes that are directly comparable from bank to bank."

Mahesh Narayanasami, Accounting Advisory Services, Financial Services, KPMG in the US, and Ana Rosa Cortez, Financial Services, KPMG in Spain

While banks are considering how to tackle the challenges of the new IFRS 9 impairment model, the Basel Committee joined the discussions in February 2015 by issuing *Guidance on accounting for expected credit losses* – proposals that include the Basel Committee's perspective on how internationally active banks should implement the impairment requirements of IFRS 9.

The Basel Committee's emphasis is on "high quality, robust and consistent implementation of the expected credit loss accounting model".[1]

How comparable and how consistent?

One reason for issuing the proposals is the importance that the Basel Committee attaches to consistent implementation of the IFRS 9 impairment model across all jurisdictions. Paragraph 3 of the proposals states that the aim of the guidance is "to drive consistent interpretations and practices, where there are commonalities and when the same accounting framework is applied". Principle 8 states that "A bank's public reporting should promote transparency and comparability."

The proposals do not explain what is meant by consistent implementation and, equally important, what is not. Consistency is an important concept underlying both prudential and financial reporting. However, it is also a concept open to different interpretations. For example, it can refer to consistency of processes or consistency of outcome, to reporting by different parts of the same organisation, to reporting by the same organisation over time or to reporting by different organisations.

IFRSs are principles-based standards and the interpretation of principles involves the application of judgement. This is especially so for impairment, because estimating impairment is an art rather than a science. This is the case with the current incurred loss model in IAS 39 and even more so for the new expected credit loss impairment model in IFRS 9, which widens the scope of the judgement and increases its potential impact on the amount of impairment losses recognised by banks. A consistent interpretation of IFRS 9 would not necessarily result in a consistent outcome because the latter has to reflect entity-specific facts and circumstances and reasonable judgement exercised by management.

The asset quality review of the 130 largest banks of the eurozone carried out in 2014 by the European Central Bank (ECB) showed that regulators look at consistency in the sense of comparability between different entities. The review involved a substantial amount of preparation to ensure that data was presented on a comparable basis – e.g. introducing a standard definition of non-performing exposures (NPE) to be used by all banks involved in the exercise, which led to an increase in the volume of NPE held by those banks by €135 billion.

We support the principle of consistent interpretation of accounting standards, but note that consistent interpretation of the impairment requirements of IFRS 9 may not result in outcomes that are directly comparable from bank to bank.

Higher implementation costs

Operationalising the new IFRS 9 impairment methodology is challenging because of its significant impact on a bank's systems and processes. During the process of developing the new model, the IASB had considered its potential operational challenges – e.g. to fully understand the consequences of the first exposure draft released in 2009, the Board sought input from a panel of credit risk experts. Subsequently, a number of simplifications were introduced, which were meant to ease the operational impact without being detrimental to the model's integrity.

1. Paragraph 7 of Guidance on accounting for expected credit losses, Basel Committee, February 2015.

The Basel Committee's proposals would remove some of these simplifications and, as a result, increase the complexity of implementing IFRS 9. For example:

- under IFRS 9, an entity may assume that the credit risk on a financial instrument has not increased significantly since initial recognition if the financial instrument is determined to have low credit risk at the reporting date. The proposals state that using the low credit risk exemption in IFRS 9 would reflect a low-quality implementation of the impairment model. The proposals would apply only to loans and not to debt securities, for which the exemption is probably most likely to be used. However, the exemption could also apply to larger commercial loans; and
- IFRS 9 requires entities to use reasonable and supportable information that is available without undue cost or effort. However, the proposals state that the cost of obtaining the relevant information is not considered to be likely to involve undue cost and effort. The proposals acknowledge that a high-quality, robust and consistent implementation of IFRS 9 is likely to require costly up-front investments in new systems and processes, but nevertheless the Basel Committee considers the long-term benefit to outweigh the costs and therefore does not consider the costs 'undue'[2].

In contrast to the accounting requirements, the proposals appear to be drafted without consideration of materiality, and the proposed high implementation threshold may lead to potentially high implementation costs while achieving only insignificant marginal improvements to reporting. For example, this may arise from the use of the following expressions: 'accurately', 'full spectrum'[3], 'all lending' and 'any relevant regional differences'[4]. Also, the factors[5] listed as potential evidence of a significant increase in credit risk appear to be just evidence of an increase in credit risk.

Although the scope of the proposals means that the guidance is meant for large, internationally active banks, there is a risk that the requirements may be adopted by national regulators and applied to a wider spectrum of financial institutions. The proposals state that "supervisors may adopt a proportionate approach with regard to the standards that they impose on banks" and that this "allows less complex banks to adopt approaches commensurate with the size, nature and complexity of banks". However, it would be helpful for supervisors in different jurisdictions if the guidance contained examples of how the requirements (for both credit risk management and implementation of the accounting models) might be adjusted to achieve proportionality.

In addition, even large, internationally active banks have smaller portfolios for which a simplified method of implementing the new impairment model would not result in a materially different outcome but could potentially involve disproportionate cost. For these smaller portfolios, banks may have only limited data to build statistically valid expected credit loss models.

There are other areas of implementation that could benefit from practical guidance on how the requirements could be operationalised – e.g. how to incorporate into the assessment of 'significant increase in credit risk' the fact that the probability of default may be a curve over a given time horizon and, therefore, even if the credit-worthiness of the borrower is unchanged, the probability of default on a loan due from that borrower would change over time.

Although IASB representatives given the opportunity to comment on this document did not identify any aspects that would prevent a bank from meeting the impairment requirements of IFRS 9, the proposals introduce a new rebuttable presumption that lending to the same customer at a higher rate indicates that there has been a significant increase in credit risk. This may introduce a level of bias that was not originally intended by the Board.

2. Paragraph A46 of the proposals.
3. Paragraphs 30 and 53 of the proposals.
4. Paragraph A28 of the proposals.
5. Paragraph A27 of the proposals.

Using delinquency data

The proposals state[6] that the Basel Committee believes that "delinquency data are generally backward-looking, and will seldom be appropriate in the implementation of an ECL [expected credit loss] approach by banks". Although the statement is included in the part of the document discussing significant increases in credit risk, it appears to be drafted more widely as applying to other aspects of the model.

For an assessment under IFRS 9 of whether there has been a significant increase in credit risk, delinquency data would, in most cases, need to be supplemented by more forward-looking information – e.g. by considering the impact of macroeconomic factors on a portfolio level. However, delinquency data forms an important backbone of any impairment model. Banks develop probabilities of default on the basis of historical data, which is an objective measure of how similar exposures have performed in the past and gives a good starting point for considering what might happen in the future. The historical data requires an overlay of forward-looking information, but its validity as a core ingredient of any model should be acknowledged.

For example, IFRS 9 states that for periods that are far in the future an entity may extrapolate projections from available detailed information[7] and that, in some cases, unadjusted historical information may be the best reasonable and supportable information[8].

Definition of default

The proposals recommend that banks align their definitions of default for the purposes of IFRS 9 with the regulatory definition[9]. However, the European Banking Authority (EBA) recently stated[10] that the application of the definition of default has been recognised as one of the areas that have contributed to discrepancies in banks' risk-weighted asset calculations. These discrepancies stem partly from different supervisory practices and national regulations in various jurisdictions. In such cases, applying the regulatory definition of default for accounting purposes could potentially reduce comparability between different banks.

In addition, in certain EU countries and for certain types of exposures the absolute default threshold is considered to be 180 days. This is in excess of the 90-day rebuttable presumption in IFRS 9 and so can lead to misalignment between regulatory and accounting requirements.

Next steps

Regulators and standard setters share a common interest in high-quality financial reporting. We think that banking regulators have an important role to play in overseeing the quality of implementation of accounting standards, and that they should work with other stakeholders towards achieving that objective. We also believe that the goal of consistent interpretation of the impairment requirements of IFRS 9 across different entities – not only those to which the proposals apply – would benefit from stakeholders working together. Accordingly, we recommend that the Basel Committee encourage the IASB – working with its ITG – to develop further guidance that will assist in the consistent interpretation and application of IFRS 9. This would also help to prevent the increased complexity of implementing IFRS 9 caused by the need to comply with multiple, and potentially inconsistent, sets of guidance issued by different stakeholders.

6. Paragraph A22 of the proposals.
7. Paragraph B5.5.50 of IFRS 9.
8. Paragraph B5.5.52 of IFRS 9.
9. Paragraph A4 of the proposals.
10. Discussion Paper: Future of the IRB Approach, EBA/DP/2015/01, March 2015.

HOW DO YOU COMPARE? FUNDING VALUE ADJUSTMENT

> **"**Many banks with material derivative holdings have decided to incorporate the FVA into derivative prices for the purposes of their financial reporting.**"**

As noted on page 19, the International Valuation Standards Council (IVSC) has issued interim guidance on acceptable ways to estimate credit and debit valuation adjustments when measuring the fair value of derivatives. The IVSC has a separate project on funding valuation adjustments (FVAs), the outcome of which may impact some of the guidance in its paper.

Although discussions on the FVA continue, many banks with material derivative holdings have decided to incorporate the FVA into derivative prices for the purposes of their financial reporting. Here, we look at disclosures made in this area in 10 banks' 2014 financial statements.

What's the issue?

The FVA is an adjustment to the measurement of uncollateralised derivatives – or collateralised derivatives whose terms of agreement do not permit the re-use of the collateral received – to reflect the cost of funding.

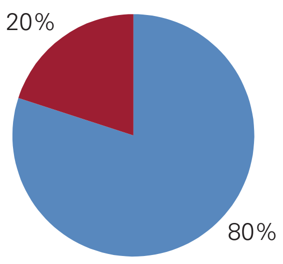
For the past few years, there has been a debate about whether, and how, to include funding costs in derivative pricing and valuation. Some argue that derivative positions should be valued using the overnight index swap curve as a risk-free proxy, with a credit valuation adjustment and debit valuation adjustment. Others argue that risk-neutral assumptions do not apply in the real world and so an FVA is necessary.

What did banks disclose?

We looked at 10 financial statements for the year ended 31 December 2014 issued by European banks reporting under IFRS to compare their disclosures in this area.

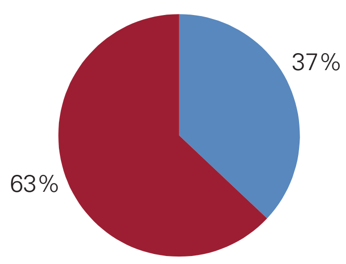
How many banks disclosed the adjustment?

Disclosure of FVA



Disclosing FVA
Not disclosing FVA

First year of disclosure



2014
Earlier than 2014

These charts show that many banks with material derivative holdings now believe that an FVA should be incorporated into pricing. Around 37 percent of the banks disclosing the impacts of the FVA had applied it for the first time in 2014.

All of the banks that applied an FVA disclosed its net impact on profit or loss, which was mostly negative – i.e. funding costs exceeded funding benefits.

How did they calculate FVA?

In general, the description of how the FVA was calculated was brief, but the level of detail varied, with some banks providing no explanation of their methodologies. A number of banks disclosed that their methodology may be refined in future as industry practice develops.

The explanations provided included the following.

- In most cases, banks specified that they had calculated the FVA on uncollateralised and partially collateralised derivative positions, and one bank also mentioned that the calculation included trades whose terms of agreement did not allow the re-hypothecation of collateral received.
- One bank disclosed that its FVA incorporated a scaling factor, which is an estimate of the extent to which the cost of funding is incorporated into observed traded levels. This bank also disclosed the monetary impact of the scaling factor.
- One bank disclosed that the FVA did not generally have an impact on the classification of individual transactions under the fair value hierarchy.

REGULATION IN ACTION: LEVERAGE RATIO – ARE BANKS READY?

> "To manage the effort needed for the new calculation, banks are keen to understand to what extent the measure of exposure is different from the total assets published in their audited financial statements."

To manage the effort needed for the new calculation, banks are keen to understand to what extent the measure of exposure is different from the total assets published in their audited financial statements.

Excessive leverage in the banking system was identified as one of the underlying causes of the global financial crisis. In response, the Basel Committee introduced the leverage ratio, which limits the size of a bank's exposures in line with the amount of its capital on a non-risk-weighted basis. This article explores how some elements of the regulatory guidance interact with the IFRS accounting requirements.

The story so far

Implementation of the leverage ratio began with banks reporting to national supervisors from 1 January 2013, and will proceed with public disclosure starting from Q1 2015, although many banks have already been reporting their ratios publicly on a voluntary basis.

The leverage ratio has been presented as a simple and transparent measure of banks' riskiness, different from other risk-based ratios[11] that have long been criticised for their complexity and opacity. However, since its initial implementation, differences have emerged in banks' interpretation of the requirements, particularly relating to the netting of collateral in securities financing and repurchase transactions. As a result, revised requirements were published by the Basel Committee (known as 'BCBS270') in January 2014 (see the Q1 2014 issue of *The Bank Statement*). In October 2014, the European Commission issued the delegated act on leverage ratio[12], aligning its methodology with the revised BCBS270 requirements.

Determining the ratio

The leverage ratio is defined as Tier 1 capital (as defined by Basel III), the capital measure, divided by the exposure measure.

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

The exposure measure generally follows the accounting but, because there are differences between US GAAP and IFRS, certain adjustments as discussed below are required to produce the figure for use in calculating the leverage ratio; these also include certain specific regulatory requirements.

More complex than expected

To manage the effort needed for the new calculation, banks are keen to understand to what extent the measure of exposure is different from the total assets published in their audited financial statements. Adjustments to the amounts presented in the financial statements include:

- prudential valuation adjustments applied to items measured at fair value;
- add-ons for the counterparty credit risk of repurchase transactions and security lending transactions; and

11. Tier 1 or Tier 2 capital ratios.
12. Commission Delegated Regulation (EU) No. 2015/62 of 10 October 2014 amending Regulation (EU) No. 575/2013 of the European Parliament and of the Council with regard to the leverage ratio.

- determining the exposure value of derivatives, including credit derivatives, based on the regulatory rules of the *Capital Requirement Regulation* (CRR) – i.e. mark-to-market valuation, including potential future credit exposure.

Some aspects of the calculation have been clarified by the new guidance in BCBS270, which has been implemented in the EU via the delegated act. These include:

- the regulatory scope of consolidation is defined, which means that some 'non-banking' subsidiaries are excluded from the exposure measure perimeter;
- loans cannot be netted with deposits;
- certain off-balance sheet exposures – e.g. commitments and liquidity facilities – are included in the exposure by applying credit conversion factors (CCFs) under the Basel standardised approach for credit risk;
- for written credit derivatives, the exposure value includes the effective notional amounts referenced by the derivative contract, reduced by any negative fair value changes that have been incorporated in Tier 1 capital;
- the offsetting criteria are clarified for security financing transactions – e.g. repos and reverse repos, security lending and borrowing transactions;
- exposures resulting from transactions cleared with a qualifying central counterparty (CCP) and in which the entity acts as a clearing member (clearing arrangements) can be recognised if certain criteria are met; and
- derivative variation margins received in cash can be netted if certain criteria are met.

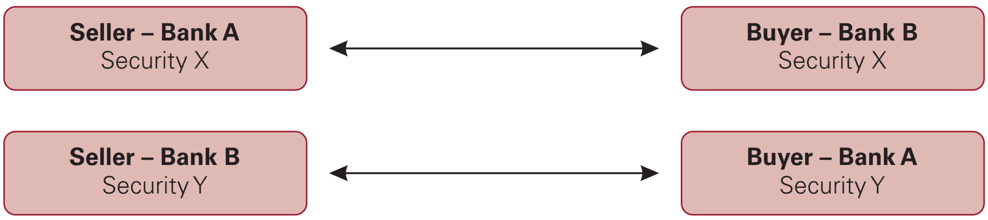
Something similar, something different

At first sight, some of the regulatory requirements on calculating the total exposure appear very similar to IFRS. However, in some cases detailed analysis may be required to determine whether adjustments are required for the purpose of calculating the leverage ratio. Below, we look into two specific areas.

Offsetting of security financing transactions

In a standard repo transaction whose repurchase price is fixed or equal to the sale price plus the lender's return, the seller of a financial asset retains all of its risks and rewards, and so does not derecognise the asset from its balance sheet. For the same reasons, a buyer of a financial asset in a standard reverse repo transaction does not recognise on its balance sheet the asset bought.

For example, consider Bank A, which has two transactions outstanding with Bank B at the reporting date: a standard repo of Security X with a sale price of 100 and a standard reverse repo of Security Y with a purchase price of 80.



Bank A has the following entries in its balance sheet to reflect these two transactions[13].

	Debit	Credit
Security X*		
Cash	100	
Payable		100
Security Y		
Receivable	80	
Cash		80

* For the purposes of this example, interest and fees are excluded.

Article 429.8 of the CRR allows Bank A to offset the payable of 100 and the receivable of 80 if the following conditions are met:

- the receivable and payable are with the same counterparty;
- the receivable and payable have the same explicit final settlement date;
- the right to set off is legally enforceable in the normal course of business and in the event of default, insolvency and bankruptcy of the counterparty; and
- the counterparties intend to settle net or settle simultaneously, or the transactions are subject to a settlement mechanism that results in the functional equivalent of settlement. A settlement mechanism results in the 'functional equivalent of net settlement' if, on the settlement date, the net result of the cash flows of the transactions under that mechanism is equal to the single net amount under net settlement.

The above criteria are similar but not identical to the offsetting requirements in IAS 32 *Financial Instruments: Presentation*. Under paragraph 42 of IAS 32, a financial asset and a financial liability are offset when, and only when, an entity:

- currently has a legally enforceable right to set off the recognised amounts; and
- intends either to settle on a net basis or to realise the asset and settle the liability simultaneously.

It appears that, although offsetting is mandatory under IAS 32 if the criteria in the standard are met, under the CRR offsetting is permitted but not required. However, because it is beneficial for a bank to offset, and so report a higher leverage ratio, most would probably offset to the extent permitted.

Under the CRR, offsetting is allowed when a receivable and payable are with the same counterparty. Under IFRS, generally, it would not be appropriate to offset assets and liabilities that a bank has with different counterparties. To qualify for offsetting, there would have to be an agreement in place between all parties, which would be unusual. Also, in practice it may be difficult to demonstrate the intention to settle net or simultaneously with all parties to the agreement.

Although there is no specific requirement in IAS 32 for the receivable and payable to have the same 'final' settlement date as under the regulatory framework, in practice if settlement dates were different it would be difficult to identify matching cash flows that could be offset.

13. For simplicity, this discussion ignores the difference between sale and repurchase price and between purchase and resale price.

The CRR requirement on the right to set off being legally enforceable appears very similar to the IAS 32 requirement that an entity currently has a legally enforceable right to set off. However, IAS 32 has more detailed guidance on the meaning of this requirement. For example, under IAS 32 an entity currently has a legally enforceable right to set off if the right is:

- not contingent on a future event; and
- enforceable both in the normal course of business and in the event of default, insolvency or bankruptcy of the entity and all of its counterparties.

Example 1 – Assessing legal enforceability

Company B enters into an agreement with Company C that gives B a right to set off.

To determine whether its right is legally enforceable in the normal course of business and in the event of default, insolvency or bankruptcy of the entity and all of the counterparties, B evaluates whether it can enforce its right in the normal course of business as well as in the case of its own default, insolvency or bankruptcy, and in the case of C's default, insolvency or bankruptcy.

In doing so, B considers whether C has any rights that do or might prevent B from enforcing its right to set off. For example, if, in the event of C's bankruptcy, C could insist on separate settlement of any amounts due to and from B, then B's right to set off would not be enforceable in those circumstances and it would not satisfy the offsetting criteria.

The CRR requirement that "the counterparties intend to settle net, to settle simultaneously, or the transactions are subject to a settlement mechanism that results in the functional equivalent of settlement" also seems very similar to the IAS 32 requirement that an entity "intends either to settle on a net basis or to realise the asset and settle the liability simultaneously". However, once again, IAS 32 contains more guidance on how this requirement should be interpreted.

If a bank can settle amounts in such a manner that the outcome is, in effect, equivalent to net settlement, then it meets the intention criterion in IAS 32. A gross settlement system is equivalent to net settlement if it has features that:

- eliminate or result in insignificant credit and liquidity risk; and
- will process receivables and payables in a single settlement process or cycle.

The gross settlement system has to have the following features:

- financial assets and financial liabilities are submitted for processing at the same point in time;
- the parties are committed to fulfilling the settlement obligation once the financial assets and financial liabilities are submitted for processing;
- once they have been submitted, there is no potential for the cash flows arising from the financial assets and financial liabilities to change (unless processing fails – see the next point);
- assets and liabilities that are collateralised with securities are settled on a system whereby the processing of the receivable or payable fails if the transfer of the related securities fails (and vice versa);
- failed transactions are re-entered for processing until they are settled;
- the same settlement institution carries out the settlement; and
- there is an intra-day credit facility that:
  - will provide sufficient overdraft amounts to each party at the settlement date; and
  - is virtually certain to be honoured if it is called on.

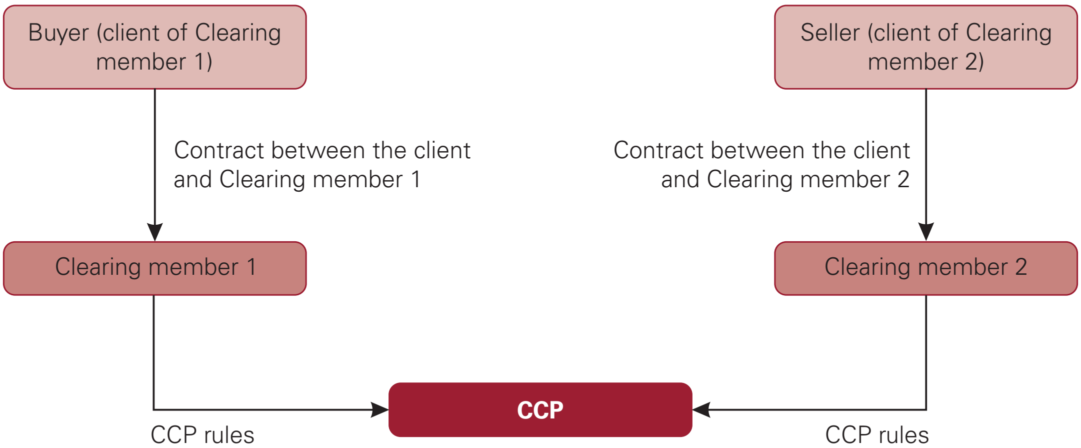
In summary, although the offsetting requirements of the CRR and IAS 32 are similar, it cannot be assumed that they will result in the same outcome and a detailed analysis of the contractual terms may be necessary to determine an appropriate treatment under each set of requirements.

Recognition of exposures resulting from transactions cleared with qualifying CCP

Clearing through CCPs can take different forms but often involves an intermediary – e.g. a clearing member. Banks often act as clearing members. A question then arises about whether the intermediary should recognise assets and liabilities subject to the clearing transaction on its balance sheet – i.e. whether the intermediary is a principal or an agent in the transaction.

Under articles 429.11–12 of the CRR, an institution that is a clearing member of a CCP may exclude from the calculation of the exposure measure trade exposures (with the CCP) of certain items – e.g. derivatives, credit derivatives and repos – if those trade exposures are cleared with a CCP unless the clearing member is obliged to reimburse the client for any losses suffered due to changes in the value of that transaction in the event that the CCP defaults.

A typical arrangement for clearing transactions through a CCP is illustrated below.



The delegated act for the CRR seems to consider the obligation to reimburse the client as the critical element for the recognition of the trade exposure.

Under IAS 39, however, an entity recognises a financial instrument on its balance sheet when it becomes a party to its contractual provisions. When a bank enters into what might be described as an 'agency relationship', an analysis is required of whether the bank is acting as an agent or as a principal in any transaction entered into as a result of that relationship. Determining this, and whether as a result the bank becomes a party to the contractual provisions of one or more financial instruments that it should recognise, may require judgement and consideration of all relevant facts and circumstances.

Example 2 – Assessing whether a party acts as agent or principal

Company S operates as a securities and derivatives broker at a stock exchange. S acts on behalf of one party, entering the customer's order (buy or sell) into the stock exchange's system. The order will be executed on the stock exchange when/if there is a corresponding counterparty offer available. The offers at the stock exchange are all given by authorised brokers acting at the exchange. It is possible for the counterparty of the deal executed at the stock exchange to be the same broker party – i.e. S acting on behalf of another customer.

The settlement term in the market in which S is the broker is trade date plus three days. After this term, S is obliged to settle the open deal if the buyer or the seller does not fulfil its part of the trade. On the settlement date, the money will be paid by the broker acting on behalf of the buyer through the central depository and the broker acting on behalf of the seller will receive the money through the central depository. The only party known to the stock exchange is the broker.

In our view, despite the fact that S is acting as an agent (on behalf) of a client, S is entering into two separate transactions: one with the stock exchange and one with the client. With respect to the transaction with the stock exchange, S is responsible for the delivery, clearing and settlement and is therefore acting as a principal in the trade. Each transaction results in a financial instrument and therefore S recognises each one separately in its statement of financial position.

Most derivative transactions cleared through CCPs involve periodic payments of receipts of the variation margin that is required by the clearing house and reflects changes in the value of the related contract. The CRR sets out specific criteria for when a variation margin can reduce the amount of exposure. Under IFRS, unless the offsetting criteria discussed above are met, recognised financial assets and financial liabilities are presented gross in the balance sheet.

Going live

Although many banks have already been reporting their ratios publicly on a voluntary basis, they will have to disclose them publicly from Q1 2015. The purpose of the leverage ratio was to have a ‘simple’ and ‘transparent’ indicator based on the accounting figures; however, as shown above, the requirements are detailed and complex, and there are differences between the accounting figures and the leverage ratio’s exposure measure.

WHERE REGULATION AND REPORTING MEET …

ESMA enforcement activities in 2014

On 31 March 2015, the European Securities and Markets Authority (ESMA) published its report[14] on the activities of accounting enforcers – including ESMA and other EU bodies – in the EU in 2014.

The report discusses the following areas:

- evaluation of the level of compliance in areas identified as common enforcement priorities for 2013;
- common enforcement priorities for 2014; and
- enforcement decisions.

It also includes a description of the main features of the European enforcement system on financial reporting and summarises ESMA's contribution to the European single rulebook.

Common enforcement priorities for 2013

In 2014, ESMA and other EU enforcers evaluated a sample of 176 IFRS annual financial statements to assess the level of compliance with IFRS in the areas identified as common enforcement priorities for 2013. The assessment focused on: impairment of non-financial assets, fair value measurement and disclosure, measurement of financial instruments, and the disclosure of related risks, including those related to forbearance activities.

The assessment identified the following shortcomings:

- insufficient information provided on forbearance practices; and
- the lack of disclosure of key assumptions made when performing impairment tests for non-financial assets with an indefinite useful life.

The review resulted in 45 enforcement actions taken by EU enforcers.

Common enforcement priorities for 2014

The common enforcement priorities for 2014 were published in October 2014[15]. In addition, in light of the number of issues identified in enforcement activities related to the implementation of IFRS 10 and the application of IAS 12 *Income Taxes* in the current economic environment, ESMA decided to include specific topics related to these two standards in its enforcement priorities for 2014 annual financial statements.

The report states that ESMA and European enforcers discussed the ECB asset quality review, its implications for IFRS financial statements and the role of accounting enforcement in this process. They considered the scope, purpose and objectives of the review to be different from theirs. However, ESMA encouraged banks to provide sufficient information on any material impact of the asset quality review on their financial statements in a specific note in their 2014 IFRS financial statements.

In 2015, ESMA plans to further reinforce its co-operation with the ECB Single Supervisory Mechanism (SSM). This will consist primarily of following up relevant issues related to the IFRS reporting of European banks, including a follow-up by ESMA and national enforcers on European banks' reporting on the asset quality review results in their 2014 IFRS financial statements.

14. Report on Enforcement and Regulatory Activities of Accounting Enforcers in 2014, ESMA/2015/659, March 2015.
15. See the Q4 2014 issue of *The Bank Statement*.

Enforcement decisions

Out of 6,400 IFRS issuers listed on EU regulated markets, EU enforcers examined the interim or annual financial statements of approximately 1,500 issuers. As a result, enforcers took action against 306 issuers.

In 2014, 47 emerging issues and 68 decisions were submitted for discussion in the European enforcers' co-ordination sessions. The following are examples of the issues most frequently discussed.

- IFRS 13: Some decisions concerned the criteria for the measurement of fair value, and in particular the existence of an active market. Enforcers considered that an issuer should consistently use quoted prices to measure the fair value of its financial assets, even though there was a decrease in the volume of activity. They concluded by noting that, according to IFRS 13, a quoted price is the best indicator of fair value in an active market.
- IAS 12 – deferred tax assets: Enforcers identified a number of instances in which significant deferred tax assets related to tax losses carried forward, and discussed the nature of the convincing evidence that justified the recognition of such assets. They identified a need for sufficient transparent disclosures on the sensitivity of the deferred tax asset to the highly judgemental assumptions in the business plans that support the existence of future taxable profits.
- IFRS 10: Several issues linked to the determination of control over an entity in the absence of a majority equity interest or a majority of voting rights in the investee were discussed. Because the concept of de facto control was only implicit in the previous applicable consolidation guidance[16], IFRS 10 could lead to a change in the assessment of whether control is achieved by an investor holding less than a majority of voting rights in an investee.

IVSC issues interim application guidance on credit and debit valuation adjustments

In January 2015, the IVSC issued interim guidance that focuses on acceptable ways to estimate credit and debit valuation adjustments when measuring the fair value of derivatives.

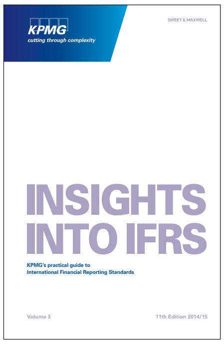
Such adjustments are required in measuring the fair value of derivatives under IFRS 13. Therefore, this interim guidance could be relevant for valuations prepared for financial reporting purposes under IFRS. It may also be relevant for calculations of the capital adequacy of financial institutions under the Basel III framework.

The IVSC has a separate project on FVAs, the outcome of which may impact some of the guidance in this paper. Accordingly, the IVSC Standards Board has issued this as interim guidance only, pending the conclusion of the FVA project. We also discuss FVAs on page 10.

16. IAS 27 *Consolidated and Separate Financial Statements*, applicable until 31 December 2012 (31 December 2013 in the EU) for banks with a calendar year end.

YOU MAY ALSO BE INTERESTED TO READ …

Insights into IFRS: Volume 3 – IFRS 9 (2014)



Builds on previous publications to bring you our first complete work of interpretative guidance based on IFRS 9 (2014).

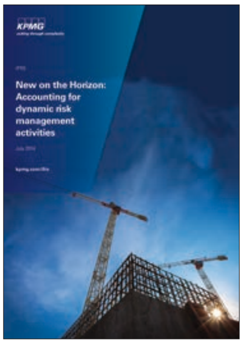
April 2015

Accounting for revenue is changing: Impact on insurance companies

A series of prompts for thinking through what the new revenue requirements could mean for insurers.

January 2015

New on the Horizon: Accounting for dynamic risk management activities



Provides detailed analysis on the IASB's discussion paper on accounting for dynamic risk management activities.

July 2014

First Impressions: IFRS 9 *Financial Instruments*

Considers the complete version of IFRS 9 *Financial Instruments*.

September 2014

IFRS Newsletter: Leases – Issues 16 and 17

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

October 2014 and March 2015

IFRS Newsletter: Insurance – Issues 43 and 44

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

September 2014 and March 2015

Click on the images above to access the publications

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