THE BANK STATEMENT

Q2 2015 NEWSLETTER

cutting through complexity

"Just asserting that a financial asset feels like a basic lending arrangement does not mean that it meets the contractual cash flows test in IFRS 9."

Reinhard Klemmer,
Financial Services,
KPMG in Singapore

COMPLEXITIES OF THE IFRS 9 SPPI ANALYSIS AND ACCOUNTING FOR CLIENT MONEY

Welcome to the Q2 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:** EFRAG issues draft endorsement advice on IFRS 9 *Financial Instruments* – see page 2.
- The IASB agrees on the future direction of its **macro hedging project** and continues discussing **financial instruments with characteristics of equity** – see page 3.
- Banks should not underestimate the impact of changes arising from **IFRS 9 classification and measurement**. We look at some of the complexities of performing the solely payment of principal and interest (SPPI) analysis – see page 5.
- **How do you compare?** We look at the Q1 2015 reports issued by 10 banks reporting under IFRS to compare their **disclosure of negative interest rates** – see page 11.
- In light of the recent focus on the leverage ratio, we discuss a few issues that arise when banks deal with **client money** – see page 12.

SPOTLIGHT ON IFRS 9

EFRAG issues draft endorsement advice on IFRS 9

On 4 May 2015, the European Financial Reporting Advisory Group (EFRAG) issued draft endorsement advice on the use of IFRS 9 *Financial Instruments* in the EU.

EFRAG's preliminary assessment is that IFRS 9 satisfies the criteria for endorsement for use in the EU and it therefore recommends its endorsement.

Stakeholders were asked to comment on all aspects of EFRAG's assessment supporting its preliminary conclusions by 30 June 2015.

Deferral of IFRS 9 for insurers

EFRAG has initially concluded that the mismatch between the effective date of IFRS 9 and that of the future insurance contracts standard will create disruption in the financial reporting of insurance activities and, accordingly, it proposes advising the European Commission to ask the IASB to defer the effective date of IFRS 9 for insurers to align it with the effective date of the future insurance contracts standard.

European IAS 39 carve-out

In addition, EFRAG has concluded that the EU carve-out from IAS 39 *Financial Instruments: Recognition and Measurement* for macro-hedging will continue to be available under IFRS 9 in accordance with the purpose for which it was intended until the IASB addresses macro hedging.

ITG discussions under way

The IFRS Transition Resource Group for Impairment of Financial Instruments (ITG) met on 22 April 2015 to discuss the following topics[1].

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

ITG members appear to have agreed on many of the issues discussed. However, some issues proved to be more challenging – for example:

- how to apply the guidance on adjusting post-balance sheet events in IAS 10 *Events after the Reporting Period* to information that becomes available after the reporting date but before the financial statements are authorised for issue; and
- how to incorporate the impact of credit risk management actions in determining the period over which the entity is expected to be exposed to credit risk on revolving credit facilities.

Two further meetings are planned, for 16 September and 11 December 2015. The chair noted that the ITG has a finite life because at a certain point in time stability in the requirements will be necessary. Therefore, the chair suggested that the ITG should have a provisional end date of 2015 and encouraged stakeholders to submit their questions in time for the ITG to discuss them this year.

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1. For a summary of the discussions, see our IFRS Newsletter: IFRS 9 impairment.

Measuring quoted investments in subsidiaries, joint ventures and associates at fair value

In April 2015, the IASB discussed the proposed example to illustrate the application of paragraph 48 of IFRS 13 *Fair Value Measurement* that was included in the exposure draft *Measuring Quoted Investments in Subsidiaries, Joint Ventures and Associates at Fair Value (Proposed Amendments to IFRS 10, IFRS 12, IAS 27, IAS 28, IAS 36 and Illustrative Examples to IFRS 13)*.

The example illustrates that, if an entity uses the exemption in paragraph 48 for a group of financial instruments that are substantially the same and are categorised within Level 1 of the fair value hierarchy, then the fair value is determined by multiplying the resulting net position by an unadjusted Level 1 price.

The IASB decided that the proposed example appropriately illustrates the application of paragraph 48 of IFRS 13.

The IASB also noted that the comments received did not indicate significant diversity in practice and that the proposed example would be non-authoritative. Accordingly, it decided that it was unnecessary to publish the example as a separate document.

New effective date for IFRS 15 proposed

In May 2015, the IASB issued its proposal to defer the effective date of IFRS 15 *Revenue from Contracts with Customers* by one year to 1 January 2018. Early adoption would continue to be permitted. The comment period ended on 3 July 2015.

In addition, later this year, the IASB plans to issue a further exposure draft to propose targeted amendments to IFRS 15 to clarify some of its requirements and add new illustrative examples.

Macro hedging: Restarting the project

In May 2015, the IASB agreed on the future direction of its macro hedging project, including deciding the following:

- the project should focus on constituents' information needs and should consider both recognition and measurement and disclosures;
- to prioritise dynamic interest rate risk management and consider other risks at a later stage; and
- to form an 'expert advisory panel' at a later stage, to assist the IASB in its deliberations.

For more information, see our *IFRS Newsletter: Financial Instruments*, May 2015.

Financial instruments with characteristics of equity

The IASB has begun its project on financial instruments with characteristics of equity by identifying the features of claims that are relevant to distinguishing between liabilities and equity.

As a first step, at its June meeting, the board discussed features that are relevant in measuring claims – namely, the:

- type of economic resource required to settle the claim;
- timing of the transfer of economic resources required to settle the claim;
- amount or quantity of economic resources required to settle the claim;
- priority of the claim relative to other claims; and
- conditions or contingencies attached to the claim.

The Board did not make any decisions during this meeting. However, Board members agreed with the features identified by the staff.

The next step for the project will be to analyse the relevance of the identified features of claims for assessment that users might make using different parts of financial statements.

For more information, see our *IFRS Newsletter: Financial Instruments*, June 2015.

IFRS 10: Single-asset, single lessee lease vehicles

In May 2015, the IFRS Interpretations Committee considered the interaction of IFRS 10 *Consolidated Financial Statements* and IAS 17 *Leases*. Two fact patterns were submitted involving a structured entity (SE) created to lease a single asset to a single lessee. One request regarded an operating lease, whereas the other regarded a finance lease. The questions were as follows.

- *Operating lease:* Should the lessee consolidate the SE?
- *Finance lease:* Should the lender consolidate the SE?

The specific question asked was whether the lessee's use of the leased asset is a relevant activity of the SE when assessing who holds power over the SE.

The Committee noted that:

- an entity has power over an investee if it has rights that give it the current ability to direct the relevant activities of the entity, and
- for both a finance lease and an operating lease, the SE (the lessor) would have two rights:
  - a right to receive lease payments; and
  - a right to the residual value of the leased asset at the end of the lease.

Consequently, the activities that would affect the SE's returns would relate to managing the returns derived from these rights – e.g. managing the credit risk associated with the lease payments or managing the leased asset at the end of its lease term.

The Committee was of the view that the lessee's right to use the leased asset for a period of time would not, in isolation, typically give it decision-making rights over these relevant activities of the SE.

However, it noted that:

- this conclusion does not mean that a lessee can never control the lessor; and
- an entity would consider all of the rights that it has in relation to the investee, including rights in contractual arrangements other than the lease contract, to determine whether it has power over the investee.

The Committee concluded that neither an interpretation of nor an amendment to a standard is required and decided not to add the issue to its agenda.

Insurance contracts project

The Board continued its discussions on the insurance project in its May and June meetings, including the interaction of the project with IFRS 9.

A final standard is no longer expected in 2015.

For more information, see our *IFRS Newsletter: Insurance*, May and June 2015.

SPPI ANALYSIS UNDER IFRS 9 – ARE ALL COMPLEXITIES ON BANKS' RADAR?

> "Some information may be readily available, but in many cases a detailed review of loan documentation will increase the implementation effort and time needed."

Reinhard Klemmer, Financial Services, KPMG in Singapore

Following the release of the completed version of IFRS 9 in July 2014, the key focus of many implementation projects has been the new expected loss model, which, for many banks, will be the most complex part of the standard to implement and is likely to have the biggest economic impact. However, banks should not underestimate the impact of other changes arising from IFRS 9 – in particular, the high level of judgement required, and the complexities involved, in an assessment of how a financial asset should be classified.

Although the IFRS 9 measurement categories for financial assets – amortised cost, fair value through other comprehensive income (FVOCI) and fair value through profit or loss (FVTPL) – are similar to those under IAS 39, the criteria for classification are significantly different. As part of the classification decision for a financial asset, the following assessments have to be made:

- whether contractual cash flows are solely payment of principal and interest (the SPPI criterion); and
- the nature of the business model in which the financial asset is held.

The assessment of whether the SPPI criterion is met is likely to require changes to a bank's current processes and systems.

This article deals with some of the challenges involved.

What is SPPI?

Only financial assets whose contractual cash flows meet the SPPI criterion can be measured at amortised cost or FVOCI – and then only if they also meet certain business model requirements.

For the purpose of assessing whether the SPPI criterion is met, IFRS 9 defines:

- 'principal' as the fair value of the financial asset at initial recognition; and
- 'interest' as consideration for the time value of money, credit risk associated with the principal amount outstanding and other basic lending risks and costs, as well as a profit margin.

The SPPI criteria are consistent with basic lending arrangements. The question that now arises is what are basic lending arrangements? The good news is that fixed-rate instruments with a stated principal and maturity – e.g. fixed-rate bullet repayment loans – typically meet the SPPI criteria. The biggest challenge for the assessment will be contracts that allow cash flows to change during the life of a financial instrument – i.e. the interest and repayment terms are not fixed. The cash flows may change in many different ways – for example:

- there may be a prepayment or extension option for the borrower or lender, or both;
- the interest rate may fluctuate in line with:
  - a benchmark interest rate;
  - an inflation index;
  - a formula aiming to reflect changes in the credit risk of the borrower;
  - the bank's option to adjust the interest rate – this could be a bank's published rate or a rate for a particular borrower; or
  - other formulas;
- the principal amount may be indexed to inflation or another variable; and
- cash flows can change as a result of delinquency or other credit events.

Prepayment option

IFRS 9 provides specific guidance on the circumstances in which a prepayment option is consistent with the SPPI criterion.

This is the case when the prepayment amount substantially represents unpaid amounts of principal and interest on the principal amount outstanding, which may include reasonable additional compensation for early repayment. 'Principal' is defined by IFRS 9 as the fair value of the financial asset at its initial recognition, and so may be different from the contractual par/nominal amount. This could create problems when an instrument is acquired at a discount or premium to par.

If a financial asset that would otherwise meet the SPPI criteria does not do so only as a result of an early prepayment feature, then it is still eligible to be measured at amortised cost or FVOCI if the following conditions are met:

- the entity acquires or originates the financial asset at a premium or discount to the contractual par-amount;
- the prepayment amount substantially represents the contractual par-amount and accrued (but unpaid) contractual interest, which may include reasonable additional compensation for early termination of the contract; and
- when the entity recognises the financial asset, the fair value of the prepayment feature is insignificant.

Modified time value of money

IFRS 9 also provides guidance on how to make the SPPI assessment when the time value of money component of interest is modified – i.e. when the relationship between the interest rate and the period for which the rate is set is imperfect. However, applying the guidance may involve significant judgement. For example, the assessment of the modified time value of money element requires judgement to:

- identify the characteristics of a benchmark instrument;
- identify reasonably possible scenarios; and
- determine whether the undiscounted contractual cash flows on the financial asset could be significantly different from the undiscounted benchmark cash flows.

Contingent event

If future cash flows could change as a result of a contingent event, then it would be necessary to assess the nature of the event. Although the nature of a contingent event is not in itself a determinative factor of whether a financial instrument meets the SPPI criterion, it may be an indicator.

Regulated interest rate

IFRS 9 provides an exception for circumstances in which, in a particular jurisdiction, the government sets interest rates that, for example, are part of a broad macroeconomic policy or aim to encourage entities to invest in a particular sector. In some of these cases, the objective of the time value of money element is not to provide consideration for only the passage of time. However, despite the general requirements of IFRS 9, these interest rates are considered a proxy for the time value of money element if the regulated interest rate provides consideration that is broadly consistent with the passage of time and does not introduce volatility in cash flows that are inconsistent with a basic lending arrangement.

Real-life examples

The following are examples of circumstances that may be encountered in real life.

- A bank has the right to change the interest rate during the life of a loan. This right may be constrained by predefined parameters or may be fully discretionary. It may be in relation to a published rate or a rate specific to a particular financial instrument. In many cases, the bank's right is accompanied by the right of the borrower to prepay a loan.
- Bonds are denominated in euro and linked to an inflation index of one of the eurozone countries.
- Market practice in a particular jurisdiction is to set the interest rate as a percentage of a benchmark rate.
- A loan's prepayment option contains 'make-whole'[2] provisions.
- A trigger event changes the timing and/or amount of cash flows.

The following example highlights some of the issues and the analysis that may be required. This example is simplified, and in many cases a more detailed analysis will be necessary to apply the full requirements of IFRS 9 to a bank's particular facts and circumstances.

Example 1

Bank B grants a GBP 10 million floating-rate loan to Corporate X on 1 January 2015.

Terms and conditions of the loan

- *Inception:* B transfers GBP 10 million to X (the fair value of the loan at this time is also GBP 10 million).
- *Maturity:* five years.
- *Interest rate:* one-year GBP LIBOR + 2.5%; the LIBOR component resets every three months and applies for the following three months.
- The interest rate is not regulated by a government or a regulatory authority.
- *Coupons:* due every three months at the end of the period.
- *Early repayment:* X can repay the loan early at an amount equal to par (i.e. GBP 10 million) plus accrued (but unpaid) interest plus a fee equal to 1% of the outstanding principal and interest.
- *Covenants:* on breach of any of the following limits, the interest rate is increased by 50 basis points (0.5%). If X fails to comply with the limits for two consecutive years, then B may demand repayment of the loan before maturity at an amount equal to the principal amount outstanding and accrued (but unpaid) interest.

2. E.g. on early termination the exercise price is based on the higher of:
    - the fair value of future payments of principal and interest; and
    - the principal amount plus accrued interest.

		Ratio	Year
Short–medium-term debt with banks		4.00	2015
Equity	≤	3.40	2016–2019

		Ratio	Year
Short–medium-term debt with banks		7.50	2015
EBITDA[3]	≤	5.10	2016–2019

		Ratio	Year
EBITDA	≥	3.30	2015
Interest expenses	≥	4.50	2016–2019

Other terms and conditions

There are no other terms that would preclude compliance with the SPPI criterion.

Does the loan meet the SPPI criterion?

Analysis

B needs to assess whether the contractual cash flows arising from the loan are solely payment of principal and interest on the principal amount outstanding.

The time value of money

B considers whether the time value of money element is modified and concludes that the relationship between the interest rate and the period for which the rate is set is imperfect because the rate resets every three months to a one-year rate.

B then has to determine how different the contractual, undiscounted cash flow would be if the time value of money element was not modified. To do so, B compares:

- the undiscounted cash flows of the loan under assessment – i.e. interest rate calculated as one-year LIBOR + spread where the LIBOR component resets every three months; with
- the undiscounted cash flows of a financial instrument with identical contractual terms and identical credit risk except that the variable interest rate is reset every three months to a three-month GBP LIBOR (benchmark instrument).

If the undiscounted contractual cash flows on the loan could be significantly different, then the SPPI criterion is not met.

3. EBITDA: earnings before interest, taxes, depreciation and amortisation.

In making the assessment, B considers the modification of the time value of money component in each reporting period and cumulatively over the life of the loan. It considers the relationship between one-year and three-month GBP LIBOR at the time of the analysis and whether it could change such that the contractual undiscounted cash flows over the life of the loan could be significantly different. In making the assessment, B considers reasonably possible scenarios.

The standard does not prescribe a single approach for how the benchmark test should be performed, but the following may be relevant:

- the benchmark instrument should have the same terms as the loan to be tested – e.g. maturity, payment frequency, notional and currency – and identical credit risk; and
- financial modelling will be required because future interest rate levels will not be known at the time of the analysis. Sometimes simple cash flow models may be sufficient; in other cases, more complex ones may be needed.

When making the assessment, B determines that it has made many loans on the same terms – i.e. the same modification of the time value of money element – and that this type of loan is common in the market in which B operates. However, the reason for the interest rate being set in this way is not relevant to the analysis. Also, a particular interest rate tenor mismatch does not reflect consideration for only the time value of money merely because that pricing is considered 'normal' in a particular market.

Contractual terms that change the timing or amount of contractual cash flows

B also considers whether the loan includes contractual terms that could change the timing or amount of cash flows.

The loan contains the following such terms:

- X can repay it early;
- B can demand early repayment in certain circumstances; and
- the interest rate on the loan will change if X breaches the loan covenants.

Early repayment

Under IFRS 9, a contractual term that permits the borrower to prepay a loan, or a lender to demand repayment, before maturity is consistent with the SPPI criterion if the prepayment amount substantially represents unpaid amounts of principal and interest on the principal amount outstanding. The prepayment amount may also include reasonable additional compensation for the early termination of the contract.

Because the loan was recognised at inception at its par value of GBP 10 million, a prepayment amount of par plus accrued interest would be consistent with the SPPI criterion.

B's right to demand repayment before maturity is contingent on X breaching the loan covenants. Accordingly, B has to assess the nature of the contingency (i.e. the trigger). Because the trigger event relates to breach of covenant, and so is linked to the credit-worthiness of the borrower, it seems reasonable for B to conclude that this contractual term is consistent with the SPPI criterion.

Linkage of interest to loan covenants

Additionally, B has to assess whether the contractual term that increases the interest rate by 50 basis points on breach of certain covenants is consistent with the SPPI criterion. Again, judgement is needed.

In our experience, compensation for credit risk is not always fixed at inception and it can vary in response to perceived changes in the credit-worthiness of the borrower. If there are variations in the contractual cash flows of an instrument related to credit risk, then an entity considers whether the variation can be regarded as compensation for credit risk and therefore whether the instrument may meet the SPPI criterion. In our view, it is not necessary for such a feature to reset to a current market credit spread to meet the SPPI criterion.

An instrument whose interest rate is reset to a higher rate if the debtor misses a particular payment may meet the SPPI criterion because of the relationship between missed payments and an increase in credit risk. Because the increase in interest rate can be regarded as compensation for credit risk, it seems reasonable for B to conclude that this contractual term is consistent with the SPPI criterion.

What other terms may be relevant?

Many other contractual terms may be relevant to the analysis. For example, covenants may include modifications to interest rates that are not linked to the borrower's credit-worthiness. This could be the case, for example, if the contractual interest rate on a loan increases if the borrower decides to hedge the loan with another bank rather than the lender, or if the borrower does not enter into a specified minimum number of financial transactions with the bank in a particular year. In such cases, judgement will be required to determine whether the resulting contractual cash flows meet the SPPI criterion.

In some cases, a financial asset may have contractual cash flows that are described as principal and interest but that do not represent the payment of principal and interest on the principal amount outstanding. This may be the case if the instrument represents an investment in a particular asset or cash flows. However, the fact that a financial asset is non-recourse does not necessarily prevent it from meeting the SPPI criterion. If the terms of the financial asset being evaluated limit the cash flows in a manner that is inconsistent with them representing principal and interest, then the SPPI criterion is not met.

The following contractual terms are not consistent with the SPPI criterion:

- terms that introduce exposure to risks or variability that are unrelated to a basic lending arrangement – e.g. changes in equity prices or oil prices; or
- leverage features – e.g. twice LIBOR.

However, features that have only a de minimis effect on the contractual cash flows of the financial instrument or features that are not genuine are not considered in the analysis.

Next steps

Some loans and other financial instruments issued by a bank may contain complex features and clauses that make it difficult to determine whether contractual cash flows are SPPI. Just asserting that a financial asset feels like a basic lending arrangement does not mean that it meets the contractual cash flows test in IFRS 9.

Some information relevant to the assessment may be readily available from a bank's system, but in many cases a detailed review of loan documentation will be necessary, increasing the implementation effort and the time needed.

HOW DO YOU COMPARE? NEGATIVE INTEREST RATES

> "Applying IFRS to the presentation of negative interest on assets requires judgement in light of facts, circumstances and materiality."

Negative interest rates have recently come to the fore because the benchmark interest rates for an increasing number of currencies and maturities have become negative. This raises a number of accounting issues, including how the resulting negative interest income and interest expense should be presented in the statement of comprehensive income.

What's the issue?

In January 2015, the IFRS Interpretations Committee discussed the impact of negative effective interest rates on the presentation of income and expenses in the statement of comprehensive income. It 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. The Committee also 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 to an understanding of this item.

What about materiality?

The application of IFRS to the presentation of negative interest on assets requires the application of judgement in light of facts, circumstances and materiality.

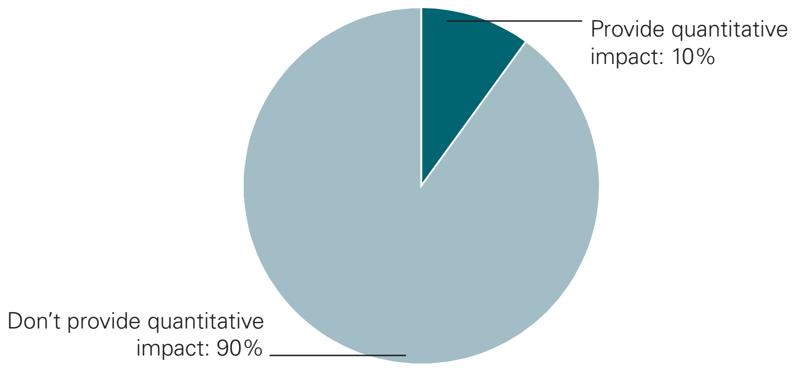
An item may be material as a result of its size or nature, or a combination of the two. In considering materiality, any prudential or financial regulatory effect of the existence or presentation of negative effective interest may be relevant – and is likely to be specific to the relevant jurisdiction.

What did banks disclose?

We looked at the Q1 2015 reports of 10 European banks reporting under IFRS, focusing our sample on banks in countries most affected by negative benchmark interest rates.

Most of the banks in our sample provided qualitative disclosures of the potential impacts of a negative interest rate on their business. One disclosed the quantitative impact on its statement of comprehensive income.

Banks providing quantitative impact of negative interest rates



The bank providing the quantitative impact did so by adding an additional line item to the statement of comprehensive income between 'interest income' and 'interest expense'. The line item was net of negative interest income and negative interest expense. Further analysis of this net item was provided in the notes.

Another bank disclosed that negative income and expenses resulting from negative interest rates were insignificant during Q1 2015 and that these amounts were offset against interest income and interest expense, respectively.

REGULATION IN ACTION: ON OR OFF-BALANCE SHEET? LEVERAGE RATIO IN FOCUS

> "The accounting analysis can be complex and is usually very specific to the facts and circumstances of each situation."

The introduction of the regulatory leverage ratio[4] has focused banks' attention on the size of their balance sheets. Some banks are therefore having a closer look at their balance sheets, and this may involve a review of their current accounting for client money – in particular, whether client money should be recognised on-balance sheet. For example, UBS in its Q4 2014 report[5] has changed its accounting policy for recognising certain client cash balances to align with evolving market practice.

A bank accepting money from clients has to consider whether the money meets the requirements for recognition on-balance sheet.

The accounting analysis can be complex and is usually very specific to the particular facts and circumstances. This article highlights some of the factors to consider.

A wide spectrum of legal arrangements

A great number of financial institutions and other entities hold money on behalf of clients, as a result of transactions requiring cash margin deposits or custody activity, or as part of other transactions conducted in the ordinary course of business (e.g. brokerage or clearing business). The terms on which this money is held can vary.

At one end of the spectrum are customers' current or deposit accounts. These accounts are not legally isolated from a bank's estate and the bank is free to use the customer's monies for its own purposes while the deposit remains with the bank. The monies received become the property of the bank and the bank assumes an obligation to repay an equivalent amount of cash to the customer. The money that is deposited is no longer the 'client's money'. In this case, the recognition criteria are typically met and so the accounts are generally recognised on the bank's balance sheet (with the double entry being debit cash, credit liability to customers).

In contrast, if:

- funds held by a bank on behalf of a client are segregated from the bank's assets and not available to the bank;
- the client has no credit recourse to the bank; and
- all interest is collected for the benefit of the client,

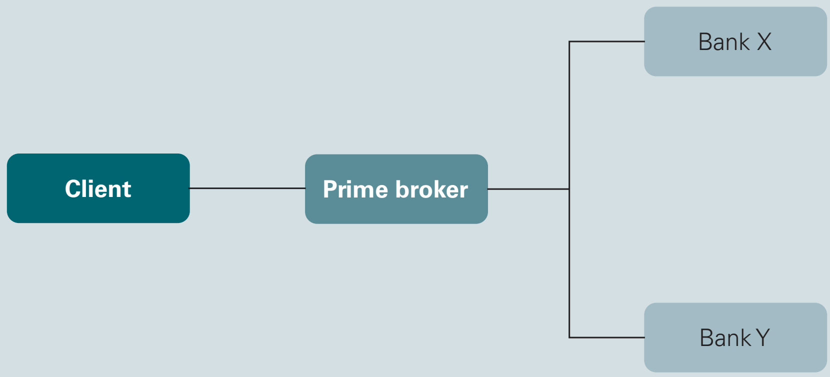
then it is likely that the recognition criteria have not been met and so the client monies are off-balance sheet.

4. See the Q1 2015 issue of *The Bank Statement*.
5. UBS Fourth Quarter 2014 Report.

The flowchart below illustrates an example of an arrangement from which client money can arise.

Prime brokerage arrangement

Under a prime brokerage arrangement, a hedge fund or investment manager (the client) typically deposits money with a prime broker, who in turn deposits the cash received with one or more third parties (sub-custodians), usually banks.



Depending on the terms of the arrangement, the client may be able to choose to have its money placed in a 'designated client account' in its sole name, or in a 'general client account' in which money from different clients is held together. In the former case, the client would generally know where its monies have been placed – e.g. in a client account with Bank X. In the latter case, the client may not know where its monies have been placed.

The question is whether the prime broker has to record the client's monies on its balance sheet.

What are the factors to consider?

IFRS does not have specific guidance on the recognition of client money. Cash is a financial asset and so IAS 39 is relevant to determining an appropriate accounting treatment. Under IAS 39, an entity recognises a financial asset on its balance sheet when it becomes a party to the contractual provisions of the instrument. An assessment of whether this is the case includes consideration of whether an entity is a party to the contractual provisions of an instrument in the capacity of a principal or in the capacity of an agent/fiduciary, acting on behalf of the client.

If a bank acts as a principal in the transaction, then it records the money received from the client on its balance sheet. In this case, the bank has an asset. The *Conceptual Framework for Financial Reporting* defines an 'asset' as a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

The following factors may be relevant for the assessment.

Exposure to credit and other risks

The questions to consider are: Who bears the risk in the event of Bank X or Bank Y being unable to repay the funds? Does the prime broker have any obligation to make good any losses suffered by the client in this situation?

The contract between the client and the prime broker may not explicitly state who bears the credit risk, and so analysis of all terms may be required and judgement may be needed to make the determination. It may be necessary to consider various potential scenarios. For example, in the event of a failure of X, there may be a delay between X entering administration and the prime broker being able to access the client account. What happens in the interim if the client asks the prime broker for its money?

Control

Who controls the cash and who receives the future economic benefits associated with it? Can the prime broker use the cash for its own purposes to realise economic benefits, or is its role purely to administer the money on behalf of the client? The following questions may also be relevant.

- Is the client's cash legally isolated from the rest of the assets of the prime broker?
- Are there limitations on what the prime broker can do with the cash?
- Who decides what the money can be used for?
- Can the cash be reinvested by the prime broker?
- If it is invested, then who bears the risks of the investments and who obtains the rewards?
- If it is permissible to use sub-custodians to hold the money, then does the client have the right to refuse the choice – or select its own?

Entitlement to interest

One of the future economic benefits of holding cash is that it can be invested and earn interest. This interest may flow in full or in part to the client or to the prime broker. Sometimes judgement may be required to determine whether a flow of money to the prime broker is compensation for specific services provided by the prime broker or whether it represents the economic benefit of interest.

Basel Committee issues net stable funding ratio disclosure standards

Following the publication of the net stable funding ratio (NSFR) standard in October 2014, on 22 June 2015 the Basel Committee on Banking Supervision issued the related disclosure requirements.

Similar to the liquidity coverage ratio (LCR) disclosure framework,[6] the requirements aim to improve the transparency of regulatory funding disclosures. They add to existing liquidity disclosure requirements such as those included in IFRS and the Enhanced Disclosure Task Force's report[7] on banks' risk disclosures.

The NSFR in brief

The objective of the NSFR is to promote funding stability by reducing banks' reliance on short-term wholesale funding and encouraging better assessment of funding risk by banks.

The NSFR is defined as the amount of available stable funding (ASF) relative to the amount of required stable funding (RSF). This ratio should be equal to at least 100 percent.

$$\frac{\text{Available stable funding}}{\text{Required stable funding}} \geq 100\%$$

ASF = The portion of capital and liabilities expected to be reliable over the time horizon considered by the NSFR, which extends to one year.

RSF = A function of the liquidity characteristics and residual maturities of the various assets held by the bank, as well as its off-balance sheet exposures.

Application of the requirements

In general, Basel rules need to be translated into national regulation to become effective. Therefore, the final requirements applicable in different countries may be affected by this process. This article focuses on the application of Basel requirements as they are written.

Which banks will have to comply with the disclosures?

The NSFR disclosure requirements will apply to all internationally active banks reporting on a consolidated basis, but may be used by other banks and for any subset of entities of an internationally active bank to ensure greater consistency and a level playing field between domestic and international banks.

When will banks have to comply?

Banks are required to comply with these disclosures from the date of the first reporting period after 1 January 2018.

6. See the Q3 2013 issue of *The Bank Statement*.
7. Enhanced Disclosure Task Force of the Financial Stability Board, Enhancing the risk disclosures of banks, October 2012.

The disclosures will have to be published with the same frequency as, and concurrently with, the publication of a bank's financial statements – i.e. typically quarterly or semi-annually – irrespective of whether the financial statements are audited.

Where will they make the report?

Banks will need to either include the disclosures in their published financial reports or, at a minimum, provide a direct and prominent link to the completed disclosures on their websites or in publicly available regulatory reports. They will also need to make available on their websites, or through publicly available regulatory reports, an archive with all templates relating to prior reporting periods.

What will be required?

The requirements include both quantitative and qualitative disclosures.

Quantitative information explains how the NSFR has been calculated by providing components of ASF and RSF; this information will be given in a common disclosure table. Assets and liabilities will be analysed into prescribed maturity bands and both weighted and unweighted amounts will be given.

In addition, banks will be required to provide sufficient qualitative information to facilitate an understanding of the quantitative data.

Interaction with accounting and other disclosure requirements

There are other requirements for liquidity disclosures. The following table provides an overview of the disclosures required by IFRS and recommended by the EDTF report.

	IFRS 7 *Financial Instruments: Disclosures*	**EDTF report**
Where disclosed?	• Audited financial statements.	• Not specified, but the report suggests that banks may want to incorporate information into their annual report or Pillar 3 disclosures.
Qualitative disclosures	• For each type of risk (including liquidity risk) arising from financial instruments: – the exposure to risk and how it arises; – the objectives, policies and processes for managing the risk and the methods used to measure it; and – any changes in these points since the previous period.	• An explanation of: – how the bank manages its potential liquidity needs; – the possible limitations on the use of the liquidity reserve; and – the bank's funding strategy, including key sources and funding concentrations, including reliance on wholesale funding.

	IFRS 7 ***Financial Instruments: Disclosures***	**EDTF report**
Quantitative disclosures	• Summary quantitative data about exposure to risk (including liquidity risk) based on information provided internally to key management and an explanation of the basis on which the amounts are compiled. • A maturity analysis for non-derivative and certain derivative financial liabilities. • A description of how entities manage the liquidity risk inherent in the previous two points. • The carrying amount of financial assets that the bank has pledged as collateral.	• An analysis of the liquidity reserve. • A summary of encumbered and unencumbered assets. • An analysis of assets, liabilities and off-balance sheet items by remaining contractual maturity, accompanied by a discussion of their behavioural characteristics.

Banks may want to leverage some of their existing disclosures to comply with the requirements of the NSFR. However, there are differences between some of the specific disclosures required/recommended by different bodies, and so care will be needed to collect and aggregate data in a way that is appropriate to meet these varied requirements. In addition, care will be needed to ensure that disclosures are made on a consistent basis, irrespective of where they are located or which department within a bank generates the numbers.

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

IFRS Newsletter: Financial Instruments – Issues 23 and 24

Follows the IASB's deliberations on amendments to financial instruments accounting, including macro hedge accounting.

May and June 2015

First Impressions: IFRS 9 Financial Instruments

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

September 2014

IFRS Newsletter: IFRS 9 Impairment – Issue 1

Highlights the discussions of the IFRS Transition Group for Impairment of Financial Instruments on the impairment requirements of IFRS 9.

April 2015

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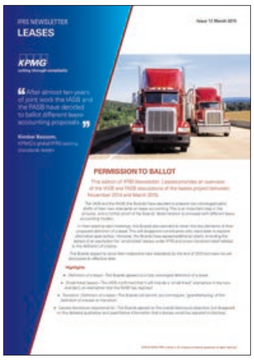

Highlights the recent discussions of the IASB and the FASB on some aspects of their lease accounting proposals published in 2013.

October 2014 and March 2015

IFRS Newsletter: Insurance – Issues 45 and 46

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

May and June 2015

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