Q2 2016 NEWSLETTER

KPMG

The Bank Statement

IFRS – Global Banking Newsletter

"The impact of IFRS 16 on banks will not be limited to their role as lessees. Banks acting as lessors will also need to consider the challenges that will be faced by their clients."

– **Charlotte Lo**
  Banking Accounting Advisory,
  KPMG in the UK

– **Giorgio Vergani**
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Impact of IFRS 16 and more on the leverage ratio

Welcome to the Q2 2016 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.

Spotlight on IFRS 9

ARC reaches consensus to endorse IFRS 9 in the EU – see page 2.

How banks may be affected by IFRS 16

The IASB has issued IFRS 16 *Leases*, the new standard that changes lease accounting and will result in bringing many more transactions on lessees' balance sheets. The new requirements will affect banks and financial institutions both in their role as lessees and lessors – see page 7.

How do you compare? Trends for the leverage ratio

We look at ten large European banks reporting under IFRS to see what they have disclosed and how their leverage ratio has changed over the last three years – see page 15.

Regulation in action: Basel III leverage ratio – one year on

The article focuses on how a bank's accounting may impact the exposure measure which is inversely correlated with the LR – see page 17.

Spotlight on IFRS 9

ESMA encourages listed companies to provide timely and relevant information on the expected impacts of IFRS 9 and IFRS 15.

ESMA encourages provision of timely information on IFRS 9 and IFRS 15

On 29 March 2016, the European Securities and Markets Authority (ESMA) issued its report *Enforcement and Regulatory Activities of Accounting Enforcers in 2015*. The report refers to ESMA's plans to issue two statements to inform the market and encourage listed companies to provide timely and relevant information on the expected impacts of IFRS 9 *Financial Instruments* and IFRS 15 *Revenue from Contracts with Customers*. ESMA notes that IFRS 9 is expected to have a major impact on the financial statements of financial institutions, mainly because of the material increase in the impairment losses, which will affect performance and will require major changes in IT systems. ESMA expects IFRS 15 to have an impact on all entities because it provides guidance on revenue.

The Q4 2015 issue of The Bank Statement discussed the Enhanced Disclosure Task Force's (EDTF) December 2015 recommendations on disclosing the impacts of IFRS 9. The EDTF stressed that the timing of disclosure of quantitative and qualitative information should be weighed against the reliability of that information.

ARC reaches consensus to endorse IFRS 9 in the EU

On 27 June 2016, the Accounting Regulatory Committee (ARC) gave a positive opinion by consensus on an EC Commission Regulation endorsing IFRS 9 in the EU.

The draft Regulation will now be submitted to the European Parliament and the Council for a three-month scrutiny period. In the absence of objections from co-legislators, the Regulation will be adopted in October this year.

GPPC publishes a paper on implementing IFRS 9 impairment requirements

In June 2016, the Global Public Policy Committee (GPPC) – which comprises representatives from BDO, Deloitte, EY, Grant Thornton, KPMG and PwC – published a joint paper, *The implementation of IFRS 9 impairment requirements by banks: Considerations for those charged with governance of systemically important banks*.

The paper seeks to help audit committees identify the elements of a high-quality implementation of IFRS 9's impairment requirements and to evaluate management's progress during the implementation and transition phase. The paper includes:

- recommendations on governance and controls;
- factors affecting selection of modelling approaches; and
- ten key questions for audit committees to use to focus their discussions with management.

For more information, see our web article.

FASB issues its accounting standard on Credit Losses

On 16 June 2016 the FASB issued *ASU 2016 – 13 Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*.

For public business entities that are US Securities and Exchange Commission (SEC) filers, the new requirements will be effective for fiscal years beginning after 15 December 2019.

Impact of IFRS 9 on insurers

The IASB has finished its discussions on the differing effective dates of IFRS 9 and the forthcoming insurance contracts standard. Among the final details agreed in the May IASB meeting are:

- a grace period for entities that apply the temporary exemption and subsequently cease to be eligible for it, to give them time to implement IFRS 9;
- permission for qualifying first-time adopters of IFRS to use the amendments; and
- confirmation of a fixed expiry date of 1 January 2021 for the temporary exemption.

The balloting process will now begin and the amendments to IFRS 4 *Insurance Contracts* are expected to be published in September 2016.

For more information, see our IFRS Newsletter: Insurance, May and June 2016.

IASB activities affecting your bank

The IFRS Interpretations Committee tentatively decided to develop a draft interpretation on accounting for long-term interests.

IFRS 9 and IAS 28 – Measurement of long-term interests

In May 2016, the IFRS Interpretations Committee (the Committee) discussed the interaction between IFRS 9 and IAS 28 *Investments in Associates and Joint Ventures* with respect to the measurement of long-term interests that form part of the net investment in an associate or a joint venture, and to which the equity method is not applied. In particular, the question relates to whether an entity applies IFRS 9, IAS 28 or a combination of both standards.

The Committee observed that the scope exception in IFRS 9.2.1(a) applies only to interests in an associate or a joint venture that an entity accounts for using the equity method and that long-term interests are subject only to one part of the equity-method procedures – i.e. the allocation of losses.

Accordingly, the Committee concluded that the scope exception in IFRS 9.2.1(a) does not apply to long-term interests.

The Committee observed the following:

a. The entity applies IFRS 9 to account for long-term interests, including the impairment requirements in IFRS 9.

b. In applying the requirements in IAS 28.38 to allocate any losses of the associate or joint venture, the entity includes the carrying amount of those long-term interests (determined applying IFRS 9) as part of the net investment to which the losses are allocated.

c. The entity then applies the requirements in paragraphs IAS 28.40 and 41A–43 to assess for impairment the net investment in the associate or joint venture, of which the long-term interests are a part.

d. If an entity allocates losses or recognises impairment applying steps (b) and (c) above, the entity ignores those losses or that impairment when it accounts for long-term interests under IFRS 9 in subsequent periods.

The Committee noted the diversity in practice relating to accounting for long-term interests and that the issue is widespread. Consequently, it tentatively decided to develop a draft Interpretation that would explain how to account for long-term interests.

IFRS 9 – Fees and costs included in the 10 percent test for the derecognition of liabilities

In May 2016, the Committee discussed the requirements in IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9 relating to which fees and costs should be included in the '10 percent' test for the purpose of determining whether a modified financial liability should be derecognised.

The Committee observed that:

– IAS 39.AG62 and IFRS 9.B3.3.6 require an entity to include 'any fees paid net of any fees received' in the '10 percent' test.

– IAS 39 and IFRS 9 distinguish between 'fees paid or received between the parties to the contract' and 'transaction costs'. The Committee noted that the objective of the '10 percent' test is to quantitatively assess the significance of any difference between the old and new contractual terms by analysing the effect of the changes in the contractual cash flows. Consequently, the 'fees' included in the '10 percent' test are similar to the 'fees paid or received between the parties to the contract' included in the calculation of the effective interest rate.

The Committee concluded that in carrying out the '10 percent' test, an entity includes only fees paid or received between the lender and the borrower or fees paid by, or on behalf of, the lender or the borrower. It also tentatively decided not to add this issue to its agenda.

The IFRS Interpretations Committee decided not to add to its agenda the questions relating to accounting for NCI puts or derecognition of modified financial assets.

IAS 32 – Accounting for a written put option on NCI

In May 2016, the Committee discussed the following issues:

– how an entity accounts for a written put option over non-controlling interests (NCI) in its consolidated financial statements when the written put option will or may be settled by the exchange of a variable number of the parent's shares; and

– whether the parent applies the same accounting for NCI puts for which the parent has the choice to settle either in cash or with a variable number of its own equity instruments to the same value.

The Committee observed that it had discussed issues in the past relating to NCI puts that are settled in cash. Those issues are being considered as part of the Financial Instruments with Characteristics of Equity (FICE) IASB project.

The Committee also noted that the issue is too broad for it to address efficiently and that the IASB is currently considering the requirements for all derivatives on an entity's own equity comprehensively as part of the FICE project. Therefore, the Committee tentatively decided not to add this issue to its agenda.

IFRS 9/IAS 39 – Derecognition of modified financial assets

In May 2016, the Committee discussed whether to undertake a potential narrow-scope project to clarify the requirements in IFRS 9 and IAS 39 about when a modification or exchange of financial assets results in derecognition of the original asset.

The Committee observed that the circumstances in which an entity should derecognise financial assets that have been modified or exchanged is an issue that arises in practice. However, because of the broad nature of the issue, the Committee noted that it could not resolve it in an efficient manner and decided not to consider it any further.

Financial instruments with characteristics of equity

At its April 2016 meeting, the IASB continued to look at the separate presentation requirements for liabilities that depend on a residual amount, and the attribution of profit or loss and other comprehensive income (OCI) to equity claims other than ordinary shares.

At its May 2016 meeting, the Board continued its April discussions on attribution approaches – including an additional approach aimed at achieving a similar attribution to that indirectly incorporated in the calculation of diluted EPS under IAS 33 *Earnings per Share*.

To move the project forward, the Board will consider refinements to the definition of the residual amount. It will also consider further the presentation of income and expense that depend on a residual amount in profit or loss or OCI, the attribution approaches for derivative equity claims and disclosure requirements for equity claims.

For more information, see our IFRS Newsletter: Financial Instruments, April and May 2016.

Insurance contracts project

At its June meeting, the IASB discussed various sweep issues that have arisen during the balloting process of the new insurance contracts standard.

The balloting process for the forthcoming insurance contracts standard has given rise to various sweep issues.

At its June meeting, the Board discussed considerations affecting measurement of, and adjustments to, the contractual service margin, insurance finance income and expenses, and accounting for reinsurance contracts.

The Board is continuing its balloting process for the new standard and expects to discuss the effective date in the third quarter of 2016. It expects to issue the final standard around the end of 2016.

For more information, see our web article and visual guide.

How banks may be affected by IFRS 16

"IFRS 16 eliminates the current dual accounting model for lessees, which distinguishes between on-balance sheet finance leases and off-balance sheet operating leases."

– **Charlotte Lo**
Banking Accounting Advisory,
KPMG in the UK

– **Giorgio Vergani**
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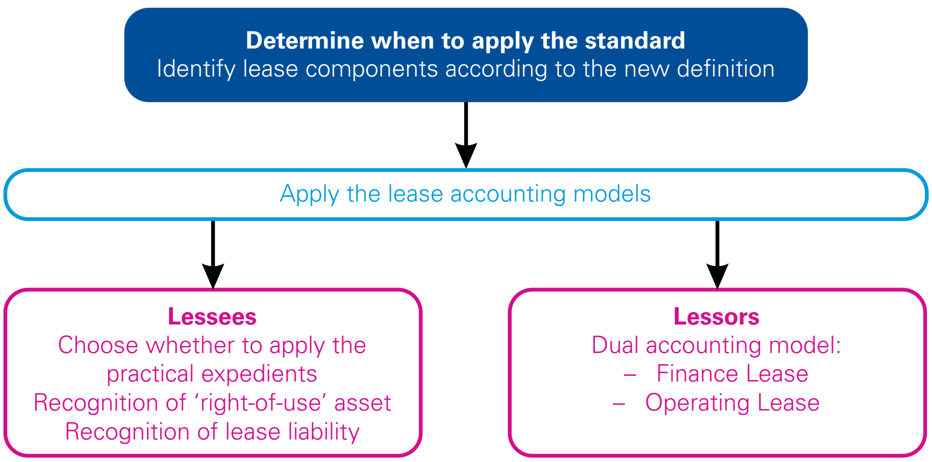
In January 2016, the IASB issued IFRS 16 *Leases*, the new standard that fundamentally changes lease accounting for lessees and will result in bringing many more transactions on lessees' balance sheets. The new requirements will affect many companies that lease assets. Banks and financial institutions will be affected both in their role as lessees and lessors. Although the effective date of IFRS 16 is not until 1 January 2019, entities should start considering the impact now because of its interrelationships with:

- IFRS 9: the new expected credit losses impairment model will apply to lease receivables recognised under IFRS 16; and
- IFRS 15: the standard applies to the recognition of revenue from service contracts with customers that do not qualify as leases under the new definition in IFRS 16, and to the non-lease components of bundled contracts that contain leases. Moreover, IFRS 16 may be adopted early but only if IFRS 15 is adopted at the same time.

What are the key changes to current lease accounting?

IFRS 16 eliminates the current dual accounting model for lessees, which distinguishes between on-balance sheet finance leases and off-balance sheet operating leases. Instead, it introduces a single on-balance sheet accounting model that is similar to current finance lease accounting. The impact is not limited to the balance sheet. In particular, entities will now recognise a front-loaded pattern of expense for most leases, even when they pay constant annual rentals. Lessor accounting remains similar to current practice – i.e. lessors continue to classify leases as finance or operating leases. However, there are some changes that should be considered.

The diagram below illustrates the key concepts in lessee and lessor accounting.

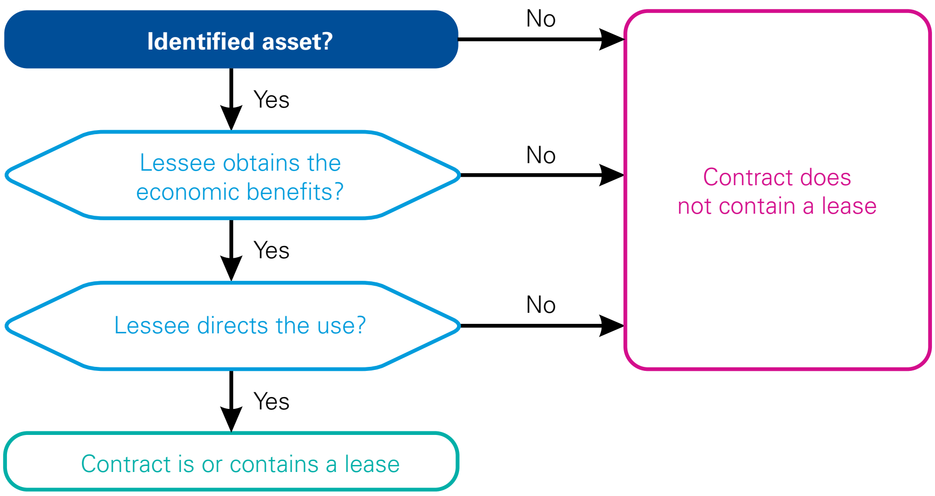


New definition of a lease

When an entity enters into a contract for the use of a specified asset, IFRS 16 will require greater care to determine at inception if the contract is, or contains, a lease.

The standard defines a lease as 'a contract, or part of a contract, that conveys the right to use an asset for a period of time in exchange for consideration'. The new definition applies to lessors and lessees but is especially important for lessees. Assessing whether an arrangement contains, or is, a lease is the first critical step in determining whether it is recognised on-balance sheet (as a lease) or off-balance sheet (as a service contract) by the customer/lessee. The new definition applies both to lessees and to lessors and may require reconsidering existing contracts that previously did not qualify as leases, and vice versa. However, at the date of initial application, an entity may apply a practical expedient that allows it not to reassess whether its existing contracts are, or contain, a lease.

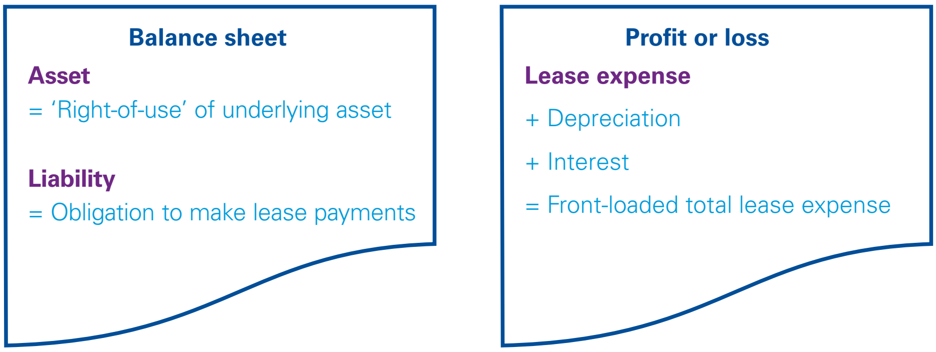
The diagram below summarises the analysis that entities will need to perform to determine whether a contract is, or contains, a lease.



Banks as lessees

Lessee accounting model

IFRS 16 requires lessees to recognise assets and liabilities for all leases with a term of more than 12 months, unless the underlying asset is of low value. The resulting accounting is summarised in the diagram below.



Measurement at initial recognition

Right of use asset

At the lease commencement date, a lessee is required to recognise an asset representing its right to use the underlying leased asset (ROU asset), and a corresponding lease liability representing its obligation to make payments under the lease. The initial cost of the ROU asset includes:

- the amount of the initial measurement of the lease liability;
- any lease payments made at or before the commencement date;
- less any lease incentives received, initial direct costs incurred by the lessee and an estimate of costs in dismantling and removing the underlying asset.

The ROU asset is in the scope of IFRS 16 rather than being specifically identified as a tangible/intangible asset in the scope of IAS 16 *Property, Plant and Equipment* or IAS 38 *Intangible Assets*. However, the ROU asset is depreciated applying the guidance in IAS 16 and is tested for impairment according to the requirements in IAS 36 *Impairment of Assets*.

The obligation to make lease payments

On initial recognition, the lease liability is measured as the present value of the lease payments, discounted using the interest rate implicit in the lease, if that rate can be readily determined, or the lessee's incremental borrowing rate. The exercise price of a purchase option is included in the lease payments if the lessee is reasonably certain to exercise that option.

Measurement subsequent to initial recognition

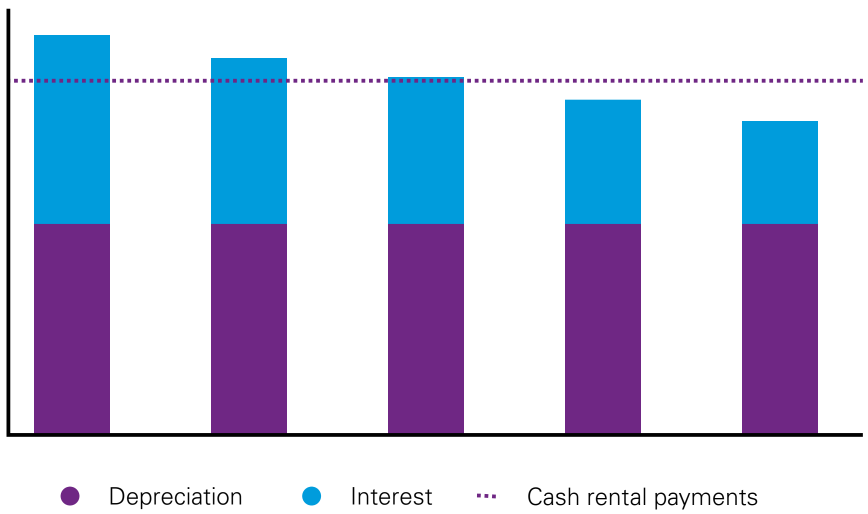
Subsequent to initial recognition:

- the lease liability is measured at amortised cost; and
- the ROU asset is measured at cost less any accumulated depreciation and any accumulated impairment losses, and adjusted for any remeasurement of the lease liability (e.g. following a contract modification).

If the ROU asset meets the definition of investment property, the entity applies IAS 40 *Investment Property* for subsequent measurement, which may be at fair value if that is the entity's selected measurement model.

The lessee's profit or loss will be impacted by a font-loaded total expense, even when lease payments (i.e. cash rentals) are constant. This is because the depreciation of the ROU asset will be on a straight-line basis but the interest expense will be recognised by applying the amortised cost to the lease liability.

This is illustrated below for an individual lease. However, the impact on a portfolio will depend on its composition. For example, a growing business that is entering into many new leases may see frontloading across the portfolio. Alternatively, a business that is in a steady state with a rolling programme of renewals may find that the frontloading averages out over the portfolio.



The new lessee accounting model will affect a bank's financial reporting because:

- its balance sheet will appear to be more asset-rich, but also more indebted; and
- interest and depreciation expenses will increase in profit or loss, and operating expenses will decrease (no more operating lease payments).

In addition, IFRS 16 requires lessees to disclose new qualitative and quantitative information, mostly related to the ROU assets and corresponding lease liabilities, and their effect on profit or loss.

Practical expedients

Banks can elect not to apply the new accounting model to leases that are:

- short-term (i.e. leases with term less than 12 months that do not contain purchase options); and
- have an underlying asset that is of 'low value' when new.

When the practical expedients are applied, payments associated with those leases are recognised by lessees as an expense on either a straight-line basis over the lease term, or another systematic basis if that basis is more representative of the pattern of the lessee's benefit. The election to apply the practical expedient for short-term leases is made by class of underlying assets to which the ROU relates. The election for leases in which the underlying asset is of 'low value' can be made on a lease-by- lease basis.

Application issues

To apply IFRS 16, banks will have to:

- identify all relevant contracts;
- assess whether those contracts convey the right to use certain assets or contain a lease;
- make accounting policy choices to apply the practical expedient to classes of short-term leases; and
- identify a threshold of 'low value' for underlying assets, considering all relevant circumstances in the market environment in which they operate.

Banks often have a wide range of lease and rental contracts in place, which will need to be (re)assessed under the new standard, including for example:

- leases of real estate (e.g. office building and branches locales);
- leases of office furniture and other equipment (e.g. copy machines);
- leases of company cars (of varying makes and value);
- leases of IT equipment (ranging from desktops and laptops to mainframes and data centres).

Leases of office furniture and equipment, desktops and laptops are likely to qualify for the recognition exemption on the basis that they are either 'low value' or are short-term. Real estate, company cars, and data centre/mainframe infrastructure are likely to meet the recognition and measurement requirements in IFRS 16 as assets on-balance sheet.

Banks as lessors

Lessor accounting model

Lessor accounting will not be symmetrical with the new lessee accounting because a lessor will continue to classify a lease as either a finance lease or an operating lease, based on the criteria currently in IAS 17 *Leases*:

- leases that transfer substantially all the risks and rewards incidental to ownership of the underlying asset are finance leases; and
- all other leases are operating leases.

However, a closer scrutiny of the new standard indicates that there may be application issues for lessors.

Application issues

Sub-lease arrangements

In some cases, a bank may be an intermediate lessor that leases an asset from a head lessor under an operating lease and leases the asset to a sub-lessee for the whole of the term of the head lease.

Under IAS 17, the bank would recognise rental expense on a straight-line basis over the head lease term and rental income in the same manner over the sub-lease term. Neither the head lease nor the sub-lease would appear on the bank's balance sheet. The impact on the bank's balance sheet would be minimal.

Under IFRS 16, the bank would:

- recognise an ROU asset and a lease liability under the head lease arrangement; and
- assess the classification of the sub-lease arrangement with reference to the terms of the ROU asset and not the underlying asset. Consequently, as the term of the sub-lease is identical to the term of the head lease, the bank will probably classify the sub-lease as a finance lease and therefore derecognise the ROU asset and recognise a finance lease receivable for the sub-lease.

The end result is recognition of a lease liability for the head lease arrangement and a finance lease receivable for the sub-lease arrangement on the bank's balance sheet.

For banks, such grossing up of the balance sheet will not be helpful, particularly if this impacts their capital and leverage ratio requirements and requires them to set aside additional capital.

Need for additional information

It will be critical for lessees to be able to identify the lease and non-lease components within payments made to lessors. If lessees are not provided with the breakdown of these components, they will need to include the entire lease payment within the ROU asset. Therefore, lessees may ask lessors to provide the breakdown of the lease and non-lease components.

In addition, lessors may need to prepare for requests from their lessees for additional information so that lessees can comply with the new disclosure requirements relating to non-lease components.

Disclosure requirements

IFRS 16 introduces limited additional disclosures for lessors – e.g. profit or loss on sale of the underlying asset, lease income not included in the net investment in the lease, and lease income relating to variable lease payments that do not depend on an index or rate.

Regulatory capital

For banks as lessees, recognising ROU assets in respect of leases previously classified as operating under IAS 17 may have a significant impact on their capital ratios, in particular their Common Equity Tier 1 (CET 1) ratio. At the time of publication of this article, regulators in many jurisdictions have not expressed a view on how the ROU asset will be treated for regulatory purposes.

IFRS 16 does not specify that the ROU asset is an intangible or tangible asset, leading to potential uncertainty over its regulatory treatment. This may be unnerving, particularly when there may be an impact on banks' capital and leverage ratios.

Some think that, as nothing has changed from a risk perspective, the accounting change introduced by IFRS 16 should not, by itself, impact the regulatory capital and leverage ratio requirements. Others fear that if the regulators adopt an approach similar to that for property, plant and equipment (PP&E), banks could see a significant increase in their risk weighted assets (RWAs).

If the latter approach is taken by regulators, banks with a large network of branches and operations will need to consider the quantitative impact as 2019 draws closer.

Sale and leaseback transactions

Lessees

A number of banks have entered into significant sale and leaseback transactions, mostly involving real estate, to deleverage their balance sheets, realise disposal gains, or to generate cash flows for funding needs. When a bank (a seller-lessee) transfers an asset to another entity (the buyer-lessor) and leases that asset back from that entity, both parties will apply the specific guidance in IFRS 16. The first step in analysing such arrangements under IFRS 16 is to assess whether the transfer is a sale according to the requirements of IFRS 15.

If it is a sale, the seller-lessee derecognises the underlying asset and recognises a gain related to the rights transferred to the buyer-lessor.

The seller then applies IFRS 16 to the leaseback, recognising an ROU asset and a lease liability. If the transfer is not a sale according to IFRS 15, then the seller-lessee continues to recognise the underlying asset and recognises a financial liability under IFRS 9 for the consideration received from the buyer-lessor (i.e. IFRS 16 does not apply).

Applying IFRS 16 to the sale and leaseback transactions will preclude the achievement of the transaction's goal to reduce the seller's balance sheet and provide off-balance sheet funding.

Lessors

Some banks are party to sale and leaseback arrangements when a customer (the seller-lessee) sells an asset to the bank (the buyer-lessor) and then leases the asset back under an operating lease. For such sale and leaseback arrangements, the bank (buyer-lessor) assesses whether it is a finance or operating lease and then recognises the underlying asset on its balance sheet – either as a finance lease receivable or PP&E.

Under IFRS 16, both lessor and lessee will be required to assess on initial transfer of the underlying asset, whether a sale has taken place in accordance with IFRS 15 before determining whether the leaseback is a lease under IFRS 16. If a sale has occurred then the leaseback arrangement will be treated as a lease and the accounting for the lessor is in accordance with IFRS 16.

Conclusion

The impact of IFRS 16 for banks will not be limited to their role as lessees. Banks that have asset finance businesses and act as lessors will also need to consider the challenges that will be faced by their customers that are IFRS preparers. There may be requests for contractual changes and/or additional information relating to lease and non-lease components.

Currently, banks are experiencing a significant amount of regulatory and accounting changes, for example, implementation of IFRS 9 and certain regulatory reporting requirements such as FINREP.[1] Such projects are expected to continue up until 2018. It is therefore important for banks to consider the data, processes and systems required to implement IFRS 16 alongside other data, process and system requirements for existing regulatory and accounting change projects.

1. Financial reporting, or FINREP, is a European regulation which applies to 'credit institutions' (e.g. banking organisations).

In addition, banks should consider whether their existing business plans envisage entering into new leases, in particular property leases, or whether there are any impending negotiations on existing[2] premises. Such arrangements may have an impact on the CET 1 ratios and should be considered alongside other ongoing regulatory and accounting change projects that may also affect the banks' CET 1 ratio.

2. In relation to extensions or renewals of leases.

How do you compare? Trends for the leverage ratio

Not surprisingly, all banks in our sample have seen their LR increase from 2013 to 2015.

As also discussed on page 17, the Basel III framework introduced a non-risk leverage ratio (LR) to act as a supplementary measure to the risk-based capital requirements. Its objectives are to restrict the build-up of leverage in the banking sector and to reinforce the risk-based requirements with a simple, non-risk based 'backstop' measure.

Banks have reported the LR to national supervisors since 1 January 2013: public disclosure requirements began on 1 January 2015.

Publication of the new requirements encouraged banks to focus on their asset exposure and equity capital, the two components of the LR. In this article we look at ten large European banks reporting under IFRS to see what they have disclosed and how their LR has changed over the last three years.

For more information on the LR calculation see the Q1 2015 issue of The Bank Statement.

What are banks required to disclose?

Details of LR disclosures before 2015 varied from bank to bank, as public disclosure was not mandatory. From 1 January 2015 Basel III[3] requires banks to disclose:

- a summary table that provides a comparison of banks' total accounting assets with total exposures used to calculate LR;
- a breakdown of the main LR regulatory elements;
- a reconciliation showing the source(s) of material differences between banks' total balance sheet assets in their financial statements and on-balance sheet exposures in the LR disclosure template.

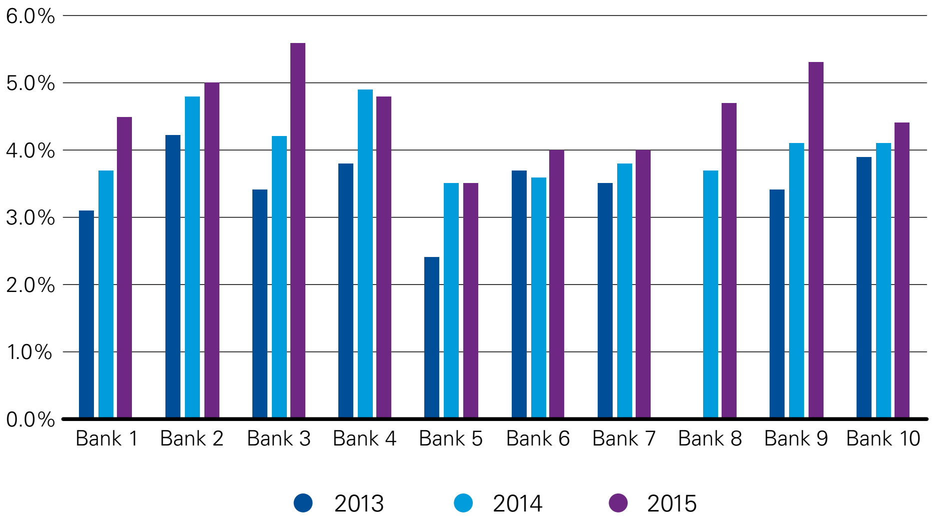
In April 2016, the Basel Committee proposed some changes to the calculation of the LR, including treatment of derivatives, provisions and off-balance sheet exposures.

3. Basel III leverage ratio framework and disclosure requirements.

How have banks' LR changed?

Perhaps not surprisingly, all banks in our sample that disclosed information for all three years have seen their LR increase from 2013 to 2015 with all LRs for the most recent two years comfortably above the minimum requirement of 3%, as shown in the diagram below.

Leverage ratio trend 2013-2015



Only a few banks provided an explanation of the key drivers behind their LR calculations. Those that did referred to reasons such as:

- additional Tier 1 (AT1) issuance;
- run-down of non-core assets/business;
- market movements;
- trade compressions;
- renegotiation and subsequent deduction of receivable assets for eligible cash variation margin provided in derivative transactions; and
- off-balance sheet exposure decrease/increase.

For most banks the consolidated total assets in their IFRS financial statements were higher than the regulatory exposure measure, although there were a few exceptions, mainly resulting from credit conversion factors applied to off-balance sheet exposures.

Regulation in action: Basel III leverage ratio – one year on

"Banks' accounting may impact the exposure measure, which is inversely correlated with the leverage ratio."

– **Silvie Koppes**
Banking Accounting Advisory, KPMG in the UK

Public disclosure of the Basel III leverage ratio (LR) has been effective from January 2015, based on the requirements published in January 2014. The Basel Committee introduced the LR as a non-risk-based supplementary measure to the risk-based capital requirements. The LR is intended to help restrict the build-up of leverage that may be present, despite apparently strong risk-based capital ratios.

In January 2016, the Basel Committee oversight body agreed that the LR should be based on a Tier 1 definition of capital and should be at least 3% – i.e. Tier 1 capital/exposure measure ≥ 3%.

The Basel Committee recently consulted on further revisions to the detailed calculations of LR. The comment period expired on 6 July 2016.

We discussed the LR in the Q1 2015 issue of The Bank Statement, but as banks have had an opportunity to work through the detail of the requirements, it has led to a better understanding of the interaction between regulatory and accounting requirements. This article focuses on how a bank's accounting may impact the denominator of the equation (i.e. the exposure measure), which is inversely correlated with the LR.

The exposure measure

The exposure measure is a calculation of asset values that generally follows the accounting value. However, detailed analysis may be required, in some cases, to determine whether any adjustments to the accounting values are required.

Netting

The presentation of financial assets and financial liabilities on a gross or net basis has a direct impact on the size of the balance sheet and so on the exposure measure. As explained in the Q1 2015 issue of The Bank Statement, although the regulatory offsetting requirements of the Capital Requirement Regulation (CRR) and IAS 32 *Financial Instruments: Presentation* are similar, they are not identical and detailed analysis of the contractual terms may be necessary to determine the appropriate treatment under each set of requirements. However, a common requirement in both frameworks is that the right to set off should be legally enforceable. For example, the legal frameworks that govern master netting arrangements or similar agreements in relation to derivatives, (reverse) repos and securities borrowing and lending arrangements may have a significant impact on the exposure measure. Following the introduction of the revised offsetting requirements and the CRR in 2014, many banks have reassessed legal enforceability of such arrangements. A reassessment often requires specialist knowledge – especially if laws in multiple jurisdictions are relevant – and in many cases involves obtaining independent legal opinions.

The application of the offsetting requirements may be operationally challenging because banks hold large amounts of financial assets and financial liabilities, and engage in multiple derivative and other transactions with financial market counterparties and clearing houses that include complex settlement and margining arrangements. A bank needs to have data and systems in place to tag, identify and match those balances that require net presentation.

Appropriate data quality and system sophistication is needed to collect such data.

Trade date vs settlement date accounting

Applying the general recognition principle in IAS 39 would result in all transactions that happen in regulated markets being accounted for on the trade date, which is when an entity becomes party to the contract. However, the standard recognises that many financial institutions and other entities use settlement date accounting for financial assets and that it would be cumbersome to account for such transactions as derivatives between the trade and settlement dates. Accordingly, for regular-way transactions an entity needs to choose either trade date or settlement date accounting. The chosen method should be applied consistently to all purchases and all sales of financial assets that are classified in the same category under IAS 39.

Trade date accounting results in the recognition of settlement receivables (payables) for financial assets sold (purchased) between the trade and settlement date.

As a result, trade date accounting under IFRS will increase the size of the balance sheet unless the balances qualify for offsetting. Settlement accounting does not cause such a balance sheet gross-up.

In its April 2016 consultation, the Basel Committee acknowledges that the timing and method for recognising regular-way purchases or sales of financial assets that have not yet been settled differ across and within accounting frameworks. Therefore, it proposes to clarify the regulatory treatment of such purchases and sales to ensure that accounting differences do not affect the calculation of the regulatory exposure.

Derecognition

Banks continue to reassess what activities are central to their strategy and are becoming more focused on their non-core portfolios and deleveraging efforts. Whilst a majority of deleveraging is expected to continue by way of natural run-off, loan portfolios are also derecognised through sales as many banks continue to restructure.

Derecognition through sales can relate either to individual instruments, to specific portfolios, or to entire businesses or operations. For individual instruments or portfolios, the derecognition criteria for financial instruments are relevant: for businesses or operations, the deconsolidation criteria are relevant. In many cases, judgement is required to assess whether a specific transaction is an actual sale that leads to derecognition.

As the LR does not take into account the riskiness of the exposures, if derecognition is achieved through sale the LR will increase only if the sales proceeds are subsequently used to reduce a bank's debt (i.e. simply turning non-core assets into core assets wouldn't change the exposure measure – to do that requires the disposal proceeds to be directed at reducing liabilities in a true deleveraging action).

We have previously discussed the impact of accounting for the initial and variation margins on the size of a banks' balance sheet. For more details see the Q2 2015 and Q1 2016 issues of The Bank Statement.

Portfolio compression

Another risk reduction measure that has a direct impact on the exposure measure is portfolio compression. Under portfolio compression, two or more counterparties terminate some or all of the derivatives executed between them either wholly or partially. They then replace the terminated derivatives with a new derivative(s) whose notional value equals the net notional value of the two terminated derivatives.

Example 1 – Bilateral portfolio compression

- Banks B and C have an existing Swap S with a notional value of 200 and a remaining maturity of five years. Under Swap S, Bank B receives fixed rate interest cash flows from Bank C and pays floating rate.
- B and C engage in a new Swap T with a five-year maturity and notional value of 100, which mirrors the cash flows of S.
- B and C enter into a compression agreement whereby swaps S and T are cancelled and replaced by a new swap N with cash flows equal to the net cash flows of compressed swaps S and T.

As a result of the compression transaction, B and C replace swaps S and T with swap N. Accordingly, B's and C's total notional exposure of 200 is reduced to 100.

Example 2 – Multilateral portfolio compression

Assume banks B, C, D and E have six swaps outstanding between them with a total absolute notional exposure of 385, a five-year maturity and identical terms except for the parties to the contract and the notional amounts.

Bank and counterparty	Notional amount
B and C	100
B and D	20
B and E	60
C and D	75
C and E	80
D and E	50
Total	**385**

The table below shows how this total notional amount could be compressed. The compression reduces the notional amounts of swaps outstanding but leaves each bank's net risk position unchanged.

Bank	Counter-party	Asset/ liability	Original notional	Amount of notional compressed	Notional after com-pression
B	C	L	(100)	(5)	(95)
B	D	A	20	20	-
B	E	L	(60)	(15)	(45)
Net risk			**(140)**		**(140)**
C	B	A	100	5	95
C	D	A	75	75	-
C	E	L	(80)	(80)	-
Net risk			**95**		**95**
D	B	L	(20)	(20)	-
D	C	A	(75)	(75)	-
D	E	A	50	(95)	(45)
Net risk			**(45)**		**(45)**
E	B	A	60	15	45
E	C	A	80	80	-
E	D	L	(50)	95	45
Net risk			**90**		**90**

In this example, bilateral compression would not reduce any risk as each bank only has one swap with each of the other banks. However, under multilateral compression summarised in the above table B, C, D and E would have the following notional amounts of derivatives in their books.

Bank and counterparty	Notional amount
B and C	95
B and E	45
D and E	45
Total	**185**

So, in summary, as a result of the compression, the total gross notional exposure of 385 is reduced to 185.

The above are simple examples that illustrate the bilateral and multilateral compression principles. Compression is especially relevant as regulators have pushed for more OTC derivatives to be processed through central clearing parties. The Q3 2015 issue of The Bank Statement explained how central clearing leads to gross-ups for clearing members if contracts do not qualify for offsetting. If contracts are subject to compression, then the offsetting question will be less relevant as notional balances would reduce as they are compressed.

The trend

As 2016 is the second year for which LR disclosure is required, it will be interesting to see what trends emerge from banks' 2016 financial statements and their Pillar 3 disclosures. It will also be interesting to understand which accounting treatments are the drivers for LR differences between banks and how new developments – e.g. changes to a clearing house's rule book – affect the LR. We have looked at some of these emerging trends on page 15.

Where regulation and reporting meet…

Although IAS 39 and IFRS 9 do not define the terms 'non-performing exposure' and 'forbearance', banks are using such terminology in their financial statements' disclosures.

The Basel Committee proposes to harmonise the definitions of non-performing exposures and forbearance

The global financial crisis revealed difficulties for supervisors and other stakeholders in identifying and comparing banks' information across jurisdictions. In response, the Basel Committee set up a task force to:

- analyse jurisdictions' and banks' practices on disclosing credit quality of their assets; and
- assess the consequences of any differences in practices.

Consequently, the Basel Committee issued a consultative document on 14 April 2016 (*Guidelines: Prudential treatment of problem assets – definitions of non-performing exposures and forbearance* (the proposals)).

EBA definitions

Many European banks will already be familiar with the definitions of 'non-performing exposures' and 'forbearance' issued by the European Banking Authority (EBA) and used by the European Central Bank to conduct the asset quality of the 130 banks in the Eurozone in 2013/2014. This topic was discussed in the Q4 2013 issue of The Bank Statement.

Common ground with IFRS

Although IFRS (IAS 39 or IFRS 9) does not define the terms 'non-performing exposure' and 'forbearance', banks are using such terminology in their financial statements' disclosures, encouraged by regulators and users. In the table below we set out some common ground between the regulatory proposals and the accounting requirements under IAS 39.

	Non-performing exposure	Forbearance	Impairment requirements of IAS 39
Scope	Applies to all credit exposures in the banking book, including: – On-balance sheet loans, debt securities and other amounts due. – Off-balance sheet items – e.g. loan commitments and financial guarantees.	Same as non-performing exposures.	– All financial assets measured at amortised cost, cost, or classified as available-for-sale. – Loan commitments and financial guarantees issued by banks are not subject to IAS 39's impairment requirements. Instead, they are subject to provisioning under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

	Non-performing exposure	Forbearance	Impairment requirements of IAS 39
Recognition criteria/ definition	– A uniform 90 days past-due criterion is applied to all types of exposures within scope. – The 90 days past-due criterion is supplemented by a set of criteria for identifying counterparties in financial difficulties.	– Concession granted to a counterparty for reasons of financial difficulties that would not otherwise be considered by the lender. – Not limited to measures that give rise to a loss for the lender.	– A financial asset is impaired and impairment losses are incurred when there is objective evidence indicating that one or more events (loss events) have occurred that have an effect on the estimated future cash flows of the asset. – A concession granted to borrowers experiencing financial difficulty is an example of a loss event. *[IAS 39.59]*
Impact of collaterali-sation	Collateralisation plays no role in the categorisation of non-performing exposures.	Not discussed in the proposals.	Not specifically discussed in the standard.
Level of application	Depending on the type of exposure as follows: – *Non-retail counterparty:* the non-performing status should be applied at the level of counterparty. – *Retail counterparty:* non-performing status can be applied at the level of each exposure.	Applied on a transaction basis.	Generally, the unit of account under IAS 39 is an individual instrument. However, if a particular exposure to a counterparty is considered impaired a bank would normally consider whether other exposures to the counterparty or a group of connected counterparties are also impaired.

	Non-performing exposure	Forbearance	Impairment requirements of IAS 39
Level of application (continued)	– *Group of connected counterparties:* non-performing status can be applied at the level of each counterparty.		
Exit criteria/ reversal of impairment	There are specific criteria to be met particularly for the amounts in arrears status and the degree of solvency of the counterparty.	Both of the following criteria should be met: – Payments as per revised terms have been made in a timely manner over a continuous period of not less than one year. – The counterparty has solved its financial difficulties.	Impairment loss of a financial asset (other than equity investment) is reversed if the amount of impairment loss decreases.

Purpose of the proposed guidelines

The proposed guidelines are intended to complement the existing accounting and regulatory framework in relation to asset categorisation, thereby promoting a better understanding of the two terms, improving identification and monitoring, and promoting consistency in the supervisory reporting and disclosures by banks.

Next steps

The comment period on the proposals expires on 15 July 2016.

EBA issues proposals to implement the revised Pillar 3 framework in the EU

In the Q4 2015 issue of The Bank Statement we discussed the revised Pillar 3 disclosures issued by the Basel Committee and the expectation that the EU law makers and regulators will make a significant effort in 2016 to implement these revised disclosure requirements in the EU. On 29 June 2016, the EBA issued a consultation paper[4] on amending the Pillar 3 framework (RPF) in the EU.

The proposals, when finalised, would allow EU banks to implement the RPF in a way that is compliant with the requirements of the existing EU regulations. They would introduce more specific guidance relating to the existing disclosure requirements on risk management, credit risk, counterparty credit risk and market risk, and provide clarification in certain areas.

The EBA has asked for comments by 29 September 2016. It expects to finalise the guidelines by the end of 2016 with application for 2017 year-end disclosures.

4. EBA/CP/2016/07

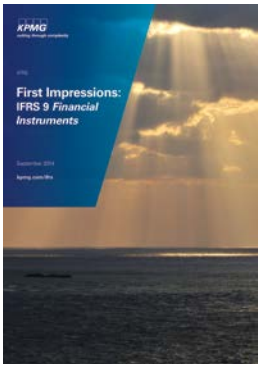
You may also be interested to read...

Insights into IFRS: 12th Edition 2015/16

Helping you apply IFRS to real transactions and arrangements. Includes our interpretative guidance based on IFRS 9 (2014).

September 2015

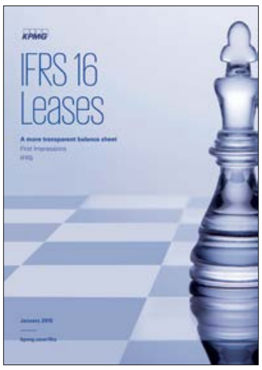
First Impressions: IFRS 9 *Financial Instruments*



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

September 2014

First Impressions: IFRS 16 *Leases*



Explains the key requirements, highlights areas that may result in a change in practice, and features KPMG insights.

January 2016

IFRS Newsletter: Financial Instruments – Issues 29 and 30

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

April and May 2016

IFRS Newsletter: IFRS 9 Impairment – Issue 3

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

December 2015

IFRS Newsletter: Insurance – Issues 54 and 55

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

May and June 2016

Click on the images above to access the publications.

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