# THE BANK STATEMENT
Q4 2014 NEWSLETTER

KPMG
*cutting through complexity*

"The macro hedging proposals have not received widespread support; stakeholders are looking to reflect risk mitigation through a flexible and voluntary hedge accounting model, rather than fair valuing all hedged and unhedged open risk positions."

**Abhimanyu Verma,**
Financial Services,
KPMG in Canada

## RESPONSE TO MACRO HEDGING PROPOSALS, AND THE IMPACT OF IFRS 9 ON REGULATORY CAPITAL

Welcome to the Q4 2014 issue of our quarterly banking newsletter in which we provide updates on IFRS developments that directly impact banks and consider the potential accounting implications of regulatory requirements.

**Highlights**

- Having finalised its new financial instruments standard earlier this year, the IASB has turned its focus to a long-running source of debate: the **distinction between liabilities and equity** – see page 2.
- The comment period for the IASB's proposals on **macro hedging** ended in October. We look at some of the **comments received** to see how stakeholders responded to the proposals – see page 6.
- **How do you compare?** This time, we look at **disclosures** under IFRS 12 *Disclosure of Interests in Other Entities* about **unconsolidated structured entities** – see page 9.
- Regulation in action: We discuss the **impact of IFRS 9** *Financial Instruments* **impairment requirements on regulatory capital** – see page 13.

# IASB ACTIVITIES AFFECTING YOUR BANK

## New project on the distinction between liabilities and equity

Having finalised its new financial instruments standard earlier this year, the IASB has turned its focus to a long-running source of debate on the distinction between liabilities and equity. As a result, in its October meeting the Board agreed to start work on its project on financial instruments with characteristics of equity, which may result in a discussion paper.

The IASB decided to pursue the following two overlapping streams of work.

- *Classification:* Investigating potential improvements to the classification of liabilities and equity in IAS 32 *Financial Instruments: Presentation*. This will also include an investigation of potential amendments to the definitions of liabilities and equity in the *Conceptual Framework for Financial Reporting*.
- *Presentation and disclosure:* Investigating potential improvements to the presentation and disclosure requirements for financial instruments with characteristics of equity, irrespective of whether they are classified as liabilities or as equity.

The IASB noted the interaction between this new research project and the separate *Conceptual Framework* project[1] as follows.

- The exposure draft for the *Conceptual Framework* will propose retaining the existing definition of equity and clarifying some aspects of the definition of a liability that are not directly related to distinguishing liabilities from equity.
- The proposed definitions of a liability and of equity to be included in the exposure draft for the *Conceptual Framework* will not constrain the work in the research project. Instead, the research project will consider various approaches to distinguishing between liabilities and equity, including approaches that could require changes to the definitions of a liability or of equity in the *Conceptual Framework*. Nevertheless, any such changes are unlikely to reverse the clarifications to be suggested in the exposure draft for the *Conceptual Framework*.

## Transition Resource Group for Impairment of Financial Instruments

In July 2014, the IASB issued the completed IFRS 9 *Financial Instruments*, which incorporates the new requirements for impairment of financial instruments.

The new impairment requirements in the form of an expected credit loss model represent a fundamental change to current practice and will therefore have a significant impact on most banks. To enhance robust and consistent implementation of the expected credit loss model, the IASB has set up the Transition Resource Group for Impairment of Financial Instruments (ITG). Chris Spall, KPMG's global financial instruments leader, is a member of the ITG.

The purpose of the ITG is:

- to solicit, analyse and discuss stakeholder issues arising from implementation of the new impairment requirements;
- to inform the IASB about those implementation issues, which will help the IASB determine what, if any, action will be needed to address those issues; and
- to provide a public forum for stakeholders to learn more about the new impairment requirements from others involved in implementation.

The ITG will not issue guidance. Meetings are planned for 22 April, 16 September and 11 December 2015, and future issues of *The Bank Statement* will include updates.

1. For more information, see the project page on the IASB's website.

## Investment entities: Applying the consolidation exception

New requirements allowing investment entities to use fair value accounting came into effect from 1 January 2014, but early adoption had already highlighted a series of application issues. In response, on 18 December 2014, the IASB issued *Investment Entities: Applying the Consolidation Exception (Amendments to IFRS 10, IFRS 12 and IAS 28)*.

Under the amendments:

- an investment entity parent is required to fair value a subsidiary providing investment-related services that is itself an investment entity;
- an intermediate parent (holding) in an investment entity group can be exempt from preparing consolidated financial statements; and
- when a non-investment entity investor applies the equity method, it is permitted to retain the fair value accounting applied by its investment entity associate or joint venture.

The amendments are effective for periods beginning on or after 1 January 2016. Early adoption is allowed.

## Classification of the liability for prepaid cards issued by a bank in the bank's financial statements

In November 2014, the IFRS Interpretations Committee discussed the classification of the liability for prepaid cards issued by a bank in the bank's financial statements and the accounting for the unspent balance of prepaid cards with the following features:

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

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

The Committee observed that the liability for prepaid cards meets the definition of a financial liability because the issuing bank has a contractual obligation to deliver cash to the merchant that is conditional on the cardholder using the prepaid card to purchase goods or services. Accordingly, IFRS 9 (IAS 39 *Financial Instruments: Recognition and Measurement*) should be applied.

However, it was concerned about similar arrangements, such as customer loyalty programmes or prepaid cards issued by non-bank entities that can only be redeemed for goods or services of the issuing entity, and asked the staff to consider the basis for a distinction between prepaid cards with the features outlined above and other similar arrangements. The Committee also asked the staff to follow the discussions of the US FASB's Emerging Issues Task Force on this issue.

## Holder's accounting for exchange of equity instruments

In November 2014, the IFRS Interpretations Committee discussed the accounting by the holder for equity instruments issued by a central bank when the central bank exchanges its original equity instruments for new ones with different terms. The submitter asked whether the holder of the equity instruments should account for this exchange under IAS 39 as a derecognition of the original equity instruments and the recognition of new instruments.

The Committee observed that:

- because of the unique nature of the transaction, this issue is not widespread; and
- the submitter had not identified significant diversity in accounting for this transaction among the holders of the equity instruments in question.

For these reasons, the Committee decided not to add this specific issue to its agenda. However, it asked the staff to prepare more analysis on the general matter of derecognition of financial assets that have been modified to identify whether an issue of sufficiently narrow scope could be identified to be raised with the IASB.

## Control of a structured entity by a junior lender

In November 2014, the IFRS Interpretations Committee discussed whether a particular party controls a structured entity that is created to lease a single asset to a single lessee and is financed by a senior and a junior lender. The submitter asked whether the junior lender controls the structured entity and so should consolidate it. The lease is a finance lease as defined by IAS 17 *Leases*.

The Committee noted that, in assessing the effect of a lease on an assessment of power made in accordance with IFRS 10 *Consolidated Financial Statements*, it is necessary to make a careful assessment of the facts and circumstances. It also noted that it is not the Committee's practice to give case-by-case advice on individual fact patterns.

The Committee concluded that the principles and guidance in IFRS 10 are sufficient to enable a determination to be made when all required information is known and that neither an interpretation nor an amendment to the standard was required. For this reason, the Committee decided not to add this issue to its agenda.

## Measuring investees at fair value: An investment-by-investment choice or a consistent policy choice?

Also in November 2014, the IFRS Interpretations Committee discussed whether the election to measure investments in associates and joint ventures at fair value is available on an investment-by-investment basis or whether it is an accounting policy that has to be applied consistently in accordance with paragraph 13 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

The submitter noted that the IASB had revised IAS 28 *Investments in Associates and Joint Ventures* in 2011 and claimed that before the revision entities were explicitly permitted to choose to measure investees using the equity method, or to measure investees at fair value, on an investment-by-investment basis. However, after the revision it had become unclear whether an entity still has the same choice.

The Committee agreed that the wording in IAS 28 (2011) is not clear on this point. Accordingly, it decided to recommend to the IASB that it clarify the wording of paragraph 18 of IAS 28 in its annual improvements to IFRS, to make clear that an entity is permitted to measure investees at fair value on an investment-by-investment basis.

## IFRS 9: Endorsement for use in the EU

On 17 December 2014, the board of the European Financial Reporting Advisory Group (EFRAG) met to decide on the approach that it wishes to pursue in providing advice to the European Commission on the endorsement of IFRS 9. EFRAG plans to issue a draft endorsement advice for public comment in Q2 2015 and to finalise the endorsement process in H2 2015.

---

**Leases project**

During Q4 2014, the IASB and the FASB continued redeliberating the proposals in the May 2013 exposure draft *Leases*.

KPMG issues newsletters about this project, among others. See page 20 for further details.

# IASB'S NEW APPROACH TO MACRO HEDGING: ARE STAKEHOLDERS EMBRACING THE PROPOSALS?

> "The DP outlines a fundamental change and not simply a modification to existing hedge accounting models, and should be considered carefully."

**Abhimanyu Verma, Partner, Financial Services, KPMG in Canada**

Banks are engaged in continuous identification, analysis and mitigation of risks arising from their activities. These include risks arising from financial instruments such as interest rate, currency and price risk. The identification, analysis and management of risks are often done at a portfolio level based on net exposures. This risk management approach is commonly referred to as 'dynamic risk management' or 'macro hedging'. Currently, under IAS 39, IFRS provides models for macro hedge accounting, albeit only for interest rate risk. While those models allow some flexibility over the general hedge accounting model, they contain restrictions that limit their ability to reflect some common dynamic risk management activities. It can therefore be difficult to fully reflect a bank's risk management activities in its financial statements, and some banks are left to focus on reducing volatility in profit or loss through proxy hedging designations rather than on reflecting their risk management activities.

## *Limitations of existing macro hedge accounting*

IAS 39 allows companies to select either a fair value hedging model or a cash flow hedging model for portfolio-level management of interest rate risk. However, these models do not necessarily portray dynamic risk management.

Typically, when managing interest rate risk, a bank's main risk management objective is to protect the net interest margin from fluctuations in interest rates due to changes in market rates and from mismatches between the maturity and/or repricing of interest-bearing assets and liabilities. Current IFRS accommodates some aspects of dynamic risk management by allowing some hedged items to be included in hedge relationships on a 'behaviouralised basis' – e.g. prepayable fixed interest rate mortgages – rather than on a contractual cash flow basis. However, this model can be applied only for hedges of interest rate risk and cannot be used for other types of risk – e.g. commodity price risk and foreign exchange risk. In addition, an entity cannot designate a *net* amount comprising both assets and liabilities. Also, under the current models certain items cannot be considered eligible hedging items – e.g. demand deposits, pipeline transactions or return on own equity – and the use of a 'bottom layer' approach is not allowed.

Banks have found the existing macro hedging model difficult to apply in practice and have questioned whether it results in useful information in their financial statements.

## *Overview of the approach outlined in the DP*

In response, in April 2014 the IASB published a discussion paper (the DP) on a new approach to macro hedge accounting that aims to better reflect companies' risk management activities.[2] The DP outlines a fundamental change and not simply a modification to existing hedge accounting models.

### Portfolio revaluation approach

To help stimulate a debate, the DP put forward one possible approach to macro hedge accounting, a 'portfolio revaluation approach' (PRA), which in some ways is similar to the fair value hedging model.

Under the PRA, managed exposures would be identified and remeasured for changes in the managed risk, with the gain or loss recognised in profit or loss. The remeasurement would be based on a present value technique. Hedging instruments would continue to be measured at FVTPL and the performance of the risk management activities would be captured by the net effect of the above measurements in profit or loss.

2. DP/2014/1 *Accounting for Dynamic Risk Management: A Portfolio Revaluation Approach to Macro Hedging*. For more information, see our publication New on the Horizon: Accounting for dynamic risk management activities.

Risks that are not managed would not be included in this approach, because this is not a full fair value model.

### Dynamic risk management

One of the key aspects of the new approach is that it would be applied to risks that are managed on a dynamic basis. Dynamic risk management is a continuous process that involves identifying, analysing and deciding whether, and how, to mitigate one or more risks associated with an 'open portfolio' – i.e. a portfolio that is subject to regular additions and removals of exposures (e.g. a loan portfolio with new loans being added and existing loans maturing or being prepaid over time).

### Eligible hedged items

The DP discusses broadening the scope of the PRA as compared with the current hedge accounting model. It sought comment on whether the following items should be eligible for inclusion in the managed exposure for interest rate risk:

- pipeline transactions – e.g. forecast volumes of drawdowns of fixed interest rate products at advertised rates;
- equity model book – i.e. companies' own equity where it is managed to earn a minimum target return similar to interest; and
- behaviouralised expected cash flows related to:
  - core demand deposit liabilities; and
  - prepayable exposures.

The DP also considers other aspects of dynamic risk management, including hedging sub-benchmark items, the use of risk limits and the roles of transfer pricing and internal funding indices.

### Two application alternatives

The DP presents two possible ways of applying the PRA.

- *Focus on dynamic risk management:* Under this approach, the PRA would apply to all dynamically managed positions regardless of whether they have been hedged.
- *Focus on risk mitigation:* The PRA would apply only when the entity has undertaken risk mitigation activities through hedging.

### Mandatory or optional application

One of the questions asked in the DP was whether applying the PRA should be mandatory or optional. Hedge accounting has historically been voluntary, so mandating the PRA for dynamic risk management activities would be a significant change.

## *The feedback*

The comment period for the DP ended in October. The Board received some 130 comment letters, mainly from preparers in the financial sector, regulators and accounting networks. It plans to analyse the feedback in Q1 2015.

### Overall reaction

Although respondents generally agreed that the DP identified the accounting issues related to the current hedge accounting model, there was some concern that the IASB had gone beyond the objective of hedge accounting in IFRS 9 and that the proposals – in particular the dynamic risk management scope alternative – could override the standard's classification and measurement requirements, potentially resulting in changes to the measurement of the entire banking book, which would conflict with the business model assessment.

### Can risk management be fully captured by accounting?

Many respondents questioned whether risk management activities are capable of being fully reflected in financial statements and whether it is possible to develop a special accounting approach that caters for all possible risk management practices. Some encouraged the IASB to reflect on whether it is possible to develop a 'one size fits all' solution.

### Which application alternative is preferable?

The scoping of the PRA is the critical factor in determining the impact of the approach. Applying the risk mitigation approach would limit the impact and stay true to the objective of the general hedge accounting model. However, applying the dynamic risk management approach – which would affect all items included in the net open position, irrespective of whether they have been hedged – would substantially increase the impact. Respondents generally did not support this latter approach, noting that it would override the classification and measurement requirements of IFRS 9 and could lead to significant volatility in profit or loss; they also questioned whether it would result in decision-useful information.

However, some constituents noted that restricting the suggested approach in the DP to mitigating risk may trigger significant operational burdens.

### Disclosures

Although respondents generally supported additional disclosures in this area, many cautioned against simply adding an additional layer of disclosures on top of what is already required. A number of respondents encouraged the IASB to consider carrying out a fundamental review of the risk disclosures of IFRS 7 *Financial Instruments: Disclosures* to ensure that they better meet the needs of the users of financial statements.

### What should the IASB do?

Many suggested that the IASB consider scaling down the project to focus on improvements to IFRS 9. Some noted that the aim of the hedge accounting project is to address mismatches created by different accounting treatments and that the project's focus should be to address such mismatches.

## *Watch this space*

Issuing the DP was the IASB's first step in this challenging project to develop a solution to concerns about the current hedge accounting models and how they interact with entities' dynamic risk management activities. The DP's proposals have not received widespread support, and the responses demonstrate that, in general, stakeholders are looking more to reflect risk mitigation in financial statements through a flexible and voluntary hedge accounting model rather than fair value through profit or loss accounting for all hedged and unhedged open risk positions.

One way forward might be to focus on amending the existing portfolio fair value hedge of interest rate risk model in IAS 39 to incorporate some of the items discussed in the DP. In addition, there may be similar changes that could be made to the general hedge accounting model in IFRS 9 that would allow an entity to better reflect dynamic risk management.

# HOW DO YOU COMPARE? DISCLOSURES ABOUT UNCONSOLIDATED STRUCTURED ENTITIES

**Judgement is required in interpreting the requirements and determining the appropriate level of detail.**

IFRS 12 *Disclosure of Interests in Other Entities* came into force on 1 January 2013[3]. It contains the disclosure requirements for entities that have interests in subsidiaries, joint arrangements, associates and unconsolidated structured entities. 'Interests' are widely defined as contractual and non-contractual involvement that exposes one entity to variability of returns from the other entity's performance.

During the financial crisis, it was perceived that there was a lack of transparency about the risks to which a reporting entity is exposed due to its involvement with structured entities. The IASB has addressed this issue by requiring specific disclosure about interests in such entities, through IFRS 12.

In this issue of *The Bank Statement*, we look at certain disclosures related to unconsolidated structured entities in the financial statements of 10 banks reporting under IFRS. Eight of the financial statements are for 2013 calendar years and two for the year to 31 October 2014. Although the EU has deferred the effective date of IFRS 12 to 2014, seven out of the eight European banks included in our sample applied the standard in 2013.

## *What is a structured entity?*

Structured entities are entities that are designed so that voting or similar rights are not the dominant factor in deciding who controls the entity. Structured entities often have some or all of the following features:

- restricted activities;
- a narrow and well-defined objective;
- insufficient equity to permit the structured entity to finance its activities without subordinated financial support; and
- financing in the form of contractually linked instruments issued to investors that create concentrations of credit or other risks (tranches).

Banks often invest in or establish such entities to achieve specific business purposes or to facilitate customer transactions – e.g. asset repackaging, securitisation and asset management.

## *What disclosure is required?*

The required disclosures aim to provide information to enable users of financial statements to evaluate the following in respect of an entity's interests in unconsolidated structured entities:

- the nature and extent of those interests; and
- the nature of, and changes in, the risks associated with those interests.

These disclosures are also required about the entity's exposure to risk from involvement that it had with unconsolidated structured entities in previous periods, even if it no longer has any contractual involvement with the structured entity at the reporting date. This includes specific disclosures about structured entities sponsored by the entity.

3. The EU postponed the effective date to 1 January 2014 but allowed early application.

In this article, we focus on the following disclosure requirements, which need particular judgement.

| Type of involvement | Required disclosures |
|---|---|
| Interest in a structured entity held at the reporting date | How the maximum exposure to loss from the interest was determined |
| Sponsored structured entity in which no interests are held at the reporting date | How the entity has determined which structured entities it has sponsored |

We also look at how banks have interpreted IFRS 12's guidance that "An entity does not necessarily have an interest in another entity solely because of a typical customer supplier relationship."[4]

## *Applying judgement*

### Determining maximum exposure to loss

Most banks in our sample disclosed how they determined the maximum exposure arising from their interests in unconsolidated entities. Their approach is summarised in the table below.

| Type of interest | Determination of maximum exposure |
|---|---|
| On-balance sheet items such as loans and securities | Carrying amount |
| Derivatives | Notional amount, carrying amount or both |
| Liquidity facilities | Undrawn amount disclosed in addition to the drawn amount |
| Credit enhancements such as guarantees | Amount guaranteed |

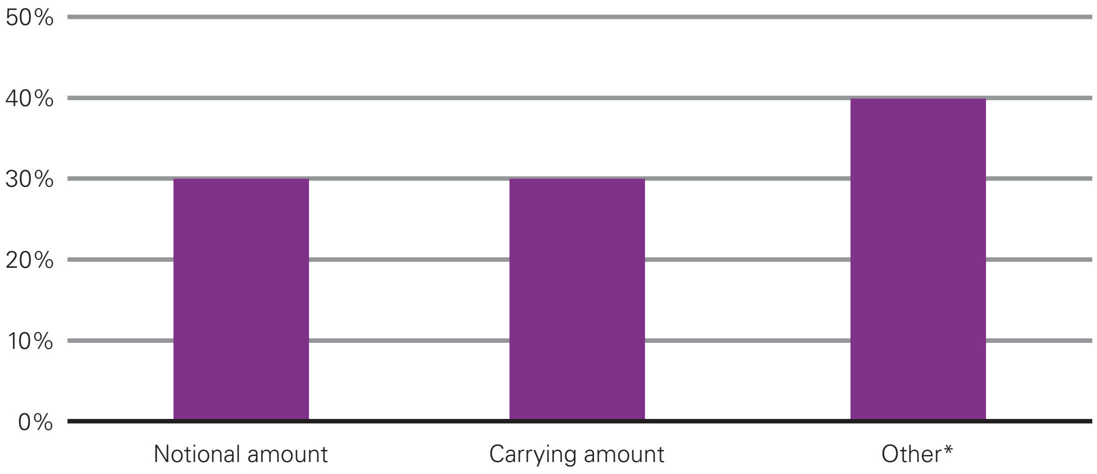
Three banks in our sample made explicit statements that certain derivative and other transactions with unconsolidated structured entities were excluded from the disclosure of maximum exposure to loss. All three banks excluded derivatives that introduced risk or variability to the structured entity rather than absorbed it. One bank also excluded interest rate swaps and foreign exchange derivatives that are not complex and exposed the bank to insignificant credit risk. Additionally, one further bank excluded insignificant exposures – i.e. those in which the bank was exposed to less than 10 percent of the unconsolidated structured entities' maximum exposure to loss.

One bank stated that, except for credit default swaps, it was not possible to estimate the maximum exposure to loss in respect of derivative positions.

The chart below provides analysis of the type of quantitative disclosures given by the banks in our sample in respect of their maximum exposure to risk for derivatives. Some banks that disclosed the carrying amounts of derivatives did not explicitly refer to the amounts as being the maximum exposures to loss.

4. Appendix A of IFRS 12.

### Maximum exposure to loss arising from derivatives

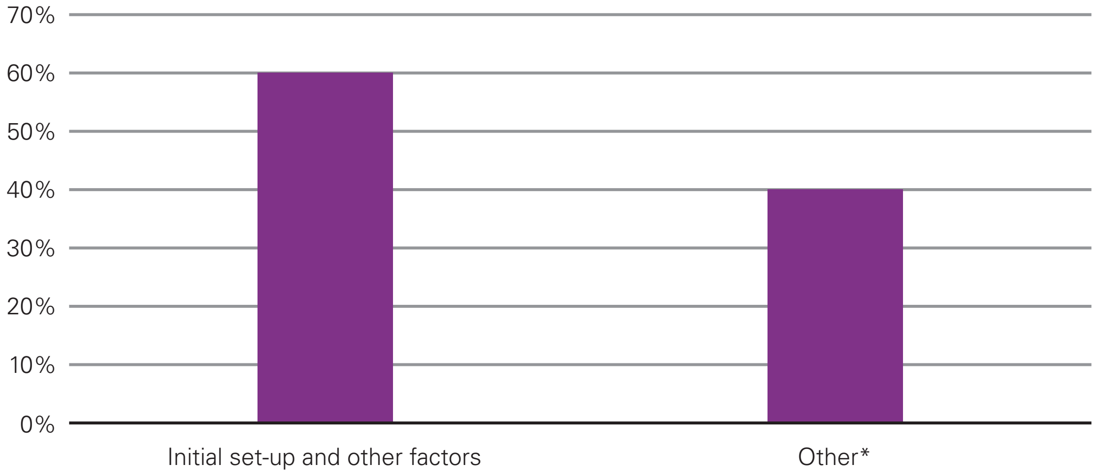



* Included in 'Other' are: one bank that did not adopt IFRS 12 and three that did not refer to derivatives or numerical disclosures.

### Determining which structured entities the bank has sponsored

Of the banks included in our sample, all of those that disclosed the criteria used to determine whether they sponsored an entity referred to their direct involvement in the initial set-up and design of the entity.

### When a structured entity is sponsored




* 'Other' includes one bank that did not adopt IFRS 12 and three that did not specify when they considered themselves to be a sponsor.

The banks in our sample included the following factors in addition to initial set-up and design:

- the bank is a majority user of the entity;
- the name of the bank appears in the name of the entity or the products issued by the entity;
- the bank provides an implicit or explicit guarantee of the entity's performance;
- the bank provides liquidity to the entity;
- the bank provides operational support to the entity;
- the bank has continuing involvement with the entity;
- a market participant would reasonably associate the entity with the bank; and/or
- the bank has transferred assets to the entity.

Some banks defined sponsor with reference to a combination of factors, whereas others defined it with reference to a single factor.

### Typical customer-supplier relationship

Only one bank in our sample made reference to the IFRS 12 statement that an entity does not necessarily have an interest in another entity solely because of a typical customer-supplier relationship. It provided summarised disclosures for its interests that arise in the ordinary course of its business, such as:

- certain commercial and corporate finance lending on which a guarantee has been provided by the parent of the structured entities; and
- trading exposures involving derivative transactions.

# REGULATION IN ACTION: IMPACT OF IFRS 9 IMPAIRMENT MODEL ON REGULATORY CAPITAL

**The impact will vary in line with the type of business that a bank engages in, the way the bank has applied IAS 39 and its approach to regulatory capital calculation.**

On 24 July 2014, the IASB issued the final version of its new standard on financial instrument accounting – IFRS 9. The standard replaces the IAS 39 incurred loss model, criticised for delaying the recognition of losses, with an expected credit loss approach that is more forward-looking. The expected credit loss model may make profit or loss and consequently equity more volatile, mainly because it makes greater use of inputs that are prone to frequent changes (e.g. credit ratings, credit spreads and estimates of future conditions) and because it uses a dual measurement method (i.e. 12-month expected losses and lifetime expected losses), with instruments moving between those methods in line with changes in their credit risk.

The new impairment model is likely to have an impact on most banks' regulatory capital under the current regulatory requirements. The magnitude of this impact will vary in line with the type of business that the bank engages in, the way the bank has applied IAS 39 and its approach to regulatory capital calculation for a particular portfolio – i.e. whether it applies the standardised or an internal rating-based (IRB) approach to credit risk capital requirements. In this article, we explore this impact. The examples shown do not illustrate any specific requirements relating to transition from IAS 39 to IFRS 9.

In addition, it is not clear whether, how or when regulators will amend the approach to the determination of capital requirements in response to the new impairment model in IFRS 9.

### *Refresher on regulatory capital*

The amount of regulatory capital that a bank has to hold is usually expressed as a ratio of capital resources to risk-weighted assets (RWA).

$$\text{Capital ratio} = \frac{\text{Capital resources}}{\text{RWA}}$$

Accounting requirements related to impairment may impact either or both the numerator and the denominator of this ratio.

### *Overview of approaches to reflecting credit risk of loans in capital requirements*

Under the Basel framework, banks may calculate their capital requirements using two general approaches: the standardised approach or an IRB approach, with the latter further split into foundation and advanced. The standardised approach is simpler because it uses parameters provided by a regulator. The latter is more complex because it requires banks to calculate some of the parameters.

The table below highlights how loss allowances for credit losses are reflected in regulatory capital and RWA under each approach.

| | Standardised | IRB |
|---|---|---|
| **Regulatory capital** | • Common Equity Tier 1 (CET1) capital includes retained earnings net of accounting loss allowances.<br>• General accounting loss allowances[5] (subject to a limit) are added to Tier 2 capital. General loss allowances are referred to under Basel[6] as general loss reserves and defined as 'reserves held against future, presently unidentified losses' – i.e. where they do not reflect an identified deterioration in a particular asset. | • The excess of expected credit losses calculated under the Basel requirements over accounting loss allowances is deducted from CET1 capital.<br>• The excess of accounting loss allowances over expected credit losses calculated under the Basel requirements is added to Tier 2 capital up to a limit. |
| **RWA (in respect of credit only)** | • RWA is calculated by applying risk weight percentages provided by the regulator to the carrying amount of assets (net of specific accounting loss allowances). | • Under the advanced approach, the RWA is calculated for each exposure on the books (i.e. it's not an average for the whole portfolio) using the probability of default (PD), loss given default (LGD) and exposure at default (EAD) estimated internally by the bank.<br>• Under the foundation approach, a regulator specifies LGD and EAD and the bank estimates the PD. |

As a result of these differences, the impact of implementing IFRS 9 on the regulatory capital ratio of a bank will be affected by whether a bank applies the standardised or the IRB approach to a particular portfolio of assets.

## *Capital requirements for portfolios under the standardised approach*

Portfolios under the standardised approach are likely to experience a greater impact on regulatory capital ratios than those under the IRB approaches. For portfolios under the standardised approach, an increase in loss allowances caused by IFRS 9 will:

- reduce retained earnings and consequently CET1; and
- reduce the carrying amounts of assets and consequently RWA.

This means that both the numerator and the denominator of the ratio will reduce, but the impact on capital is likely to be proportionately higher. This is illustrated by Example 1.

5. Known as 'general credit risk adjustments' for regulatory purposes in the EU.
6. Article 60 of *Basel III: A global regulatory framework for more resilient banks and banking systems*, Basel Committee on Banking Supervision (BCBS).

**Example 1: Impact of increased loss allowances under IFRS 9 for portfolios on the standardised approach**

The following facts are relevant for this example.

- Share capital: 300.
- Retained earnings: 200.
- Loan exposure (gross): 12,000.
- Risk weight: 50%.
- Accounting loss allowances under IAS 39: 100.
- Accounting loss allowances under IFRS 9: 150.

| CET1 (IAS 39) | CET1 (IFRS 9) |
|---|---|
| $\frac{300+(200-100)}{(12{,}000-100) \times 50\%} = 6.7\%$ | $\frac{300+(200-150)}{(12{,}000-150) \times 50\%} = 5.9\%$ |

In addition, Tier 2 capital may be affected by any differences in what is considered a 'general loss allowance' under IAS 39 and IFRS 9 because the general allowance is added to Tier 2 capital.

### *Capital requirements for portfolios under IRB approaches*

The impact on regulatory capital for portfolios under the IRB approaches is likely to be smaller. The largest impact is likely to be where accounting loss allowances under IFRS 9 exceed expected losses calculated under Basel, because in this situation the excess has to be added to Tier 2 rather than Tier 1 capital.

In contrast to the standardised approach, there will be no impact on RWA. This is because under the IRB approaches, RWA is calculated independently of the accounting carrying amounts as internally developed PD – and, for the advanced IRB approach, also LGD and EAD – and applied to the gross amount of loans, before any deduction for impairment allowances.

The potential impact for IRB portfolios is illustrated in Example 2.

**Example 2: Impact of increased loss allowances under IFRS 9 for portfolios on IRB approaches**

The following facts are relevant for this example.

- Equity: 200.
- Retained earnings: 1,000.
- Basel expected losses: 100.
- Accounting loss allowances under IAS 39: 40.

| |
|---|
| CET1 = equity + retained earnings - accounting loss allowances - EEL* |

* Excess Basel expected loss.

***Scenario A: Basel expected losses higher than IFRS 9 loss allowances***

- Accounting loss allowances under IFRS 9: 80.
- EEL over IAS 39 allowances: 60.
- EEL over IFRS 9 allowances: 20.

| CET1 ( IAS 39) | CET1 (IFRS 9) |
|---|---|
| 200 + 1,000 - 40 - 60 = 1,100 | 200 + 1,000 - 80 - 20 = 1,100 |

***Scenario B: Basel expected losses lower than IFRS 9 loss allowances***

- Accounting loss allowances under IFRS 9: 120.
- No 'excess' of Basel expected losses.

| CET1 (IAS 39) | CET1 (IFRS 9) |
|---|---|
| 200 + 1,000 - 40 - 60 = 1,100 | 200 + 1,000 - 120 = 1,080 |

In Scenario B, the IFRS 9 accounting loss allowances exceed the Basel expected losses, which is more likely to be the case than for accounting loss allowances calculated under IAS 39. CET1 is reduced by this excess. The excess is then added to Tier 2 capital, which means that total capital is the same as under IAS 39.

In addition, the amounts of CET1 and Tier 2 capital may be impacted by the level of granularity at which the comparison between accounting impairment loss allowances and regulatory expected losses are made. The more granular the approach, the larger the impact is likely to be. The regulators are still considering their approach in this area although in Europe the European Banking Authority (EBA) has proposed that the EEL calculation be performed separately only for defaulted and non-defaulted assets.

## *Watch out for BCBS developments*

The BCBS is developing proposals[7] to reduce the excessive variability of banks' capital ratios caused by the impact of calculating RWA under different approaches (standardised or IRB) and variations in internal estimates under the IRB approaches. The areas under review include:

- revising calculations under the standardised approach, including the use of floors and benchmarks;
- undertaking a more fundamental review of the modelling approaches used by banks under the IRB approaches; and
- providing additional guidance on the aspects of capital calculations that are ambiguous.

Any changes to the current regulatory framework resulting from this project may affect the way that implementation of the impairment requirements of IFRS 9 impacts the regulatory capital ratio. In addition, the BCBS has indicated that when the FASB's credit impairment project is finalised, the BCBS will examine its regulatory capital proposals to reflect the accounting changes.

7. *Reducing excessive variability in banks' regulatory capital ratios*, report to the G20, November 2014.

## ESMA to focus on ECB assessments, regulatory capital and enhanced disclosures

On 28 October 2014, the European Securities and Markets Authority (ESMA) issued its enforcement priorities for 2014 financial statements. The priorities, which have been agreed jointly with European national enforcers, are as follows:

- preparation and presentation of consolidated financial statements and related disclosures;
- financial reporting by entities that have joint arrangements and related disclosures; and
- the recognition and measurement of deferred tax assets.

In addition, ESMA set out the following specific considerations for banks for their 2014 financial statements:

- the European Central Bank (ECB) comprehensive assessment:
  - any material impact of the assessment should be explained in line with the relevant IFRS requirements. ESMA notes that this might include, for example, a change in accounting estimate, a correction of an error or changes in the way that risks arising from financial instruments are assessed, monitored and managed;
  - banks are expected to provide sufficient information on any changes in the level of regulatory capital required; and
  - the IFRS financial statements could also contain a reference to the information published in the context of the ECB's comprehensive assessment;
- ESMA reminds banks of its call for enhanced disclosures on fair value measurement, liquidity and funding risks and credit risk management (including disclosures on impaired and forborne loans, credit quality and accounting policies on impaired financial assets)[8]. It expects banks to continue their efforts to improve these disclosures when preparing their 2014 IFRS financial statements; and
- ESMA expects banks to describe the judgements made when classifying complex financial instruments as equity or as a financial liability, including an explanation of the related classification of the interest or dividend payments.

---

## Application update: ESMA enforcement decisions

On 18 November 2014, ESMA published extracts from its confidential database of enforcement decisions on financial statements[9]. Three of the decisions are likely to be of particular interest to banks.

### *Disclosure of forborne loans*

A financial institution provided a range of forbearance measures on some of the loans granted. Forborne loans amounted to an increasing proportion of the total lending. The institution considered that 'forborne loans' were not a distinct class of loans, but rather a subset of a larger class, and concluded that no specific disclosure was required. It provided a narrative description of its forbearance practices in the notes to the financial statements and further qualitative and quantitative information in a supplementary report. The majority of information in the supplementary report was referred to as unaudited.

The enforcer disagreed with the financial institution and concluded that further disclosures were required to comply with paragraphs 31, 35 and B3 of IFRS 7 and paragraph 112 of IAS 1 *Presentation of Financial Statements*. It also noted that all required disclosures on forborne loans should be included within the audited financial statements.

8. ESMA/2013/1664, *Review of Accounting Practices*, November 2013.
9. ESMA/2014/1373.

## *Fair value of consideration paid in shares*

The issuer concluded that the stock market on which the shares were traded was no longer active and that quoted prices were not a good indication of the fair value of the shares under consideration. Accordingly, it valued the shares on the basis of Level 3 inputs in accordance with paragraph 79 of IFRS 13 *Fair Value Measurement*. This conclusion was supported by the following analysis:

- a press release issued by an index provider arguing that this stock market should be classified as 'emerging market' on the basis of restrictions on in-kind transfers, off-exchange transactions and the absence of stock lending and short-selling;
- a significant decrease in average daily trading volumes over the previous five years;
- a limited average daily trading volume in comparison to total outstanding shares;
- a significant difference between minimum and maximum prices over the past 17 months; and
- a significant decrease in the stock market index (60 percent) and in market capitalisation (70 percent) over the past five years.

The enforcer disagreed with the issuer's assessment and concluded that transactions in the shares occurred on a daily basis and therefore represented a volume sufficient to determine the price on a continuous basis. It made the following observations:

- classification of the market as an emerging market did not imply that the market was inactive;
- the trading limitations were only of a short-term nature and no longer in place at the time the shares were valued;
- the analysis of volatility over a 17-month period was insufficient on its own and short-term volatility should also have been assessed; and
- paragraph B38 of IFRS 3 *Business Combinations* requires further analysis when an entity concludes that there has been a significant decrease in trading volumes because the decrease may not indicate on its own that a transaction price or quoted price does not represent fair value.

## *Recognition of a liability payable to equity holders*

A listed issuer undertook a 'scrip issue' by allocating 'free allocation rights' to its shareholders. One of the options available to shareholders was to transfer their free allocation rights back to the issuer for a fixed price.

Before the issuer's reporting date of 31 December 2012, the issuer set out the number of allocation rights to be delivered and the guaranteed fixed price at which shareholders were entitled to transfer their allocation back to the issuer. However, attribution of these rights to shareholders was made in January 2013; so, until this time, the precise number of shares to be bought back was not known.

The issuer did not account for the liability for the commitment to buy the free allocation at a fixed price in its 2012 financial statements because it believed that it was impossible to reliably determine the amount to be paid because the number of free allocations would be unknown until January 2013.

The enforcer disagreed with the issuer's assessment and concluded that a gross financial liability related to the irrevocable purchase obligation for the present value of the maximum amount payable to shareholders should have been recognised in the 2012 financial statements. It noted that:

- the free allocation rights are equivalent to a written put option because they represent the issuer's irrevocable purchase obligation and that obligation is a liability under paragraph 23 of IAS 32; and

- the issuer had set up the conditions for the share capital increase in December 2012, including the number of free allocation rights required to receive one new share and the exercise price of the purchase commitment of these rights.

### *Other decisions*

Other published enforcement decisions were on the following topics: presentation of the statement of cash flows, presentation of discontinued operations, presentation of non-current assets held for sale, deferred tax assets on disposal of a subsidiary, accounting for the effects of a specific tax regime, key assumptions used in the goodwill impairment test, disclosures related to capitalised costs, and disclosure of major customers.

---

## Inclusion of year-end profits in CET1

The *Capital Requirements Regulation*[10] (the CRR), published on 26 June 2013 and effective from 2014, may have an impact on the amounts of regulatory capital that a bank can disclose in its annual financial statements.

Article 26(2) of the CRR permits a bank to include year-end profits in CET1 when:

- it has taken a final decision on its profits; or
- it has the prior permission of the competent supervisory authority.

We understand that the EBA considers a 'final decision' to mean approval of the financial statements by shareholders, not the authorisation for issue of the financial statements by the bank's board.

The CRR states that the competent authority will grant permission if:

- those profits have been verified by the independent auditor of the accounts; and
- the institution has demonstrated that any foreseeable charge or dividend has been deducted from the amount of those profits.

Historically, many banks' annual financial statements and contemporaneous annual reports have included disclosures about regulatory capital that treat the audited year-end profits as part of CET1. This may not previously have needed the prior approval of the supervisor and banks have not generally had their year-end profits separately 'verified' by the auditor before issuing the audit report on the annual financial statements.

The introduction of article 26(2) of the CRR therefore causes some concern, because any separate verification exercise on the Q4/year-end profits ahead of the financial statements being audited and released to the market may trigger a profit announcement condition on certain exchanges. Also, there may be logistical and timing challenges in requesting the verification and seeking approval from the supervisor. Banks should assess the impact of the CRR on their planned disclosures and liaise with their supervisor to understand its specific requirements.

10. Regulation No. 575/2013 of the European Parliament and of the Council.

# YOU MAY ALSO BE INTERESTED TO READ …

### First Impressions: IFRS 9 *Financial Instruments*


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

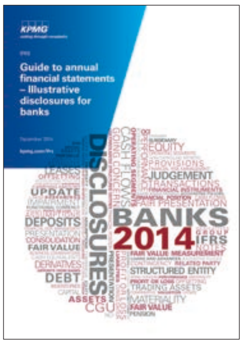
September 2014

### Accounting for revenue is changing: Impact on insurance companies


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

January 2015

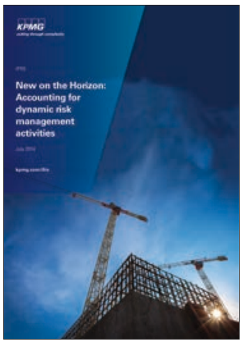
### Guide to annual financial statements – Illustrative disclosures for banks




Illustrates one possible format for financial statements based on a fictitious bank and helps to identify which disclosures may be required.

December 2014

### New on the Horizon: Accounting for dynamic risk management activities




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

July 2014

### IFRS Newsletter: Leases – Issues 15 and 16


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

June and October 2014

### IFRS Newsletter: Insurance – Issues 42 and 43


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

July and September 2014

Click on the images above to access the publications.

# BANKING CONTACTS

**Global Head of Banking**
**David Sayer**
**T:** +44 20 7311 5404
**E:** david.sayer@kpmg.co.uk

**Global Head of Capital Markets**
**Michael J Conover**
**T:** +1 212 872 6402
**E:** mconover@kpmg.com

**Argentina**
**Mauricio Eidelstein**
**T:** + 54 11 43165793
**E:** geidelstein@kpmg.com.ar

**Australia**
**Adrian Fisk**
**T:** +61 2 9335 7923
**E:** adrianfisk@kpmg.com.au

**Brazil**
**Fernando Alfredo**
**T:** +55 11 21833379
**E:** falfredo@kpmg.com.br

**Canada**
**Abhimanyu Verma**
**T:** +1 416 777 8742
**E:** averma@kpmg.ca

**China**
**Caron Hughes**
**T:** +85 22 913 2983
**E:** caron.hughes@kpmg.com

**France**
**Jean-François Dandé**
**T:** +33 1 5568 6812
**E:** jeanfrancoisdande@kpmg.fr

**Germany**
**Andreas Wolsiffer**
**T:** +49 69 9587 3864
**E:** awolsiffer@kpmg.com

**India**
**Manoj Kumar Vijai**
**T:** +91 22 3090 2493
**E:** mkumar@kpmg.com

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

**Israel**
**Danny Vitan**
**T:** +972 3 684 8000
**E:** dvitan@kpmg.com

**Italy**
**Roberto Spiller**
**T:** +39 026 7631
**E:** rspiller@kpmg.it

**Japan**
**Tomomi Mase**
**T:** +81 3 3548 5102
**E:** Tomomi.Mase@jp.kpmg.com

**Korea**
**Michael Kwon**
**T:** +82 2 2112 0217
**E:** ykwon@kr.kpmg.com

**Mexico**
**Ricardo Delfin**
**T:** +52 55 5246 8453
**E:** delfin.ricardo@kpmg.com.mx

**Netherlands**
**Peti De Wit**
**T:** +31 206 567382
**E:** dewit.peti@kpmg.nl

**Portugal**
**Ines Viegas**
**T:** +35 121 011 0002
**E:** iviegas@kpmg.com

**Singapore**
**Reinhard Klemmer**
**T:** +65 6213 2333
**E:** rklemmer2@kpmg.com.sg

**South Africa**
**Vanessa Yuill**
**T:** +27 11 647 8339
**E:** vanessa.yuill@kpmg.co.za

**Spain**
**Ana Cortez**
**T:** +34 91 451 3233
**E:** acortez@kpmg.es

**Sweden**
**Anders Torgander**
**T:** +46 8 7239266
**E:** anders.torgander@kpmg.se

**Switzerland**
**Patricia Bielmann**
**T:** +41 58 249 4188
**E:** pbielmann@kpmg.com

**UK**
**Colin Martin**
**T:** +44 20 73115184
**E:** colin.martin@kpmg.co.uk

**US**
**Michael Hall**
**T:** +1 212 872 5665
**E:** mhhall@kpmg.com

## Acknowledgements

We would like to acknowledge the efforts of the principal authors of this publication: Ewa Bialkowska, Colin Martin and Nicholas Murphy.

KPMG International Standards Group is part of KPMG IFRG Limited.

Publication name: *The Bank Statement*

Publication number: Issue 16

Publication date: January 2015



**kpmg.com/ifrs**

***The Bank Statement* is KPMG's update on accounting and reporting developments in the banking sector.**

If you would like further information on any of the matters discussed in this Newsletter, please talk to your usual local KPMG contact or call any of KPMG firms' offices.