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IFRS Today

KPMG's podcast series on IFRS and financial reporting

4 October 2018

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EPISODE 7 TRANSCRIPT

IFRS 9 year-end challenges for banks – The story that hasn't been told yet

Speakers

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- May Tiem Gillen
- James Bowe (Host)

Host

Hello and welcome to Episode 7 of *IFRS Today*, KPMG's podcast series on IFRS and financial reporting.

In this episode, we'll look at the immense challenges facing banks in the run up to what will be a far from normal year end.

I'm delighted to welcome two KPMG colleagues – here to offer some insights on the journey ahead…

First up, Colin Martin – a UK firm partner who delivers technical accounting advice to financial institutions and corporates globally on applying IFRS 9. And May Tiem Gillen – a director in Banking Accounting Advisory Services also from KPMG in the UK who assists banks of varying sizes globally on their implementation of IFRS 9.

Thank you both for joining us on *IFRS Today*…

Colin – To kick off, could you provide some brief context on what it is that makes this year end so challenging for banks?

Colin

Yes, I think the bulk of the challenge stems from new accounting literature. We've got two new standards to be applied this year – one on financial instruments and one on revenue. And one next year on leases.

But the main focus for banks is on IFRS 9 *Financial Instruments* and the banking sector is still very much at the stage of juggling the impacts, embedding the systems and internal controls needed, deploying solutions and refining those models. There's a huge job to do to get to 'business as usual' before we start and it's definitely not done yet!

On top of that change management piece, banks need to be thinking about their year-end IFRS 9 disclosures. Some banks haven't really started that process yet and it's fair to say that more than a few are going to struggle to get hold of the data they'll need to make all those required disclosures.

May Tiem

That's right, Colin, but while there's all this emphasis on IFRS 9, banks need to be careful they don't play down the impact of the revenue standard.

IFRS 15 *Revenue from Contracts with Customers* is pretty complex, with more than 25% of a bank's operating income likely to fall in its scope. It's attracting plenty of regulatory attention and yet more systems and processes will be needed to work through the judgements and estimates. The only way to get this right is with due care and attention – and proper resourcing…

Colin

And let's not forget IFRS 16 *Leases*. Preparing for the new leases requirements is going to take time to get right, as well.

May Tiem

Indeed, and the impact will be even greater if your bank has a branch network…

Colin

Good point, May Tiem.

Just coming back to IFRS 9, as it's going to be the biggest incoming challenge on the radar for banks this year. The headline around that centres on telling a story that's just never been told before.

It's easy enough to read the prescribed disclosures in IFRS 9 and IFRS 7 *Financial Instruments: Disclosures* but, because it's the first year, what nobody has yet tried to do is tell a story using those disclosures and really reconcile the difference between the opening position and the closing position over the full year using that information.

May Tiem

Absolutely. And because IFRS 9 is inherently complex, banks might struggle to get the numbers. Once they do, a lot of input will still be needed to first understand them and then to explain what they mean to analysts and investors.

Colin

Yes, and I think that one of the learning points for this year for many banks is that while you can run all the models and end up with a set of numbers, you really have to understand what's driving those changes.

Take, for example, the table of movements in the expected credit losses (ECL). What's driving the movements? Is it changes in volume, just simply issuing new loans? Is it changes in interest rates or, is it changes in other macroeconomic factors in the environment? Is it changes in payments or early maturity of previous loans? Is it changes in the credit risk parameters?

There's a whole heap of inter-related factors at play and it's going to be interesting to see how banks clearly explain how their credit risk evolves from the initial outline in that opening position through the year end.

May Tiem

You're right, Colin… What banks are essentially doing here is explaining their business models, how they manage their credit risk and how their business activities are reflected in the banks' risk measures. The danger is that because these disclosures have never been revealed before, investors and analysts may not know how to interpret them, and inadvertently misinterpret them.

So if the disclosures aren't clearly framed as a story, users of financial statements could make potentially damaging conclusions on the credit quality of a bank's portfolio, and that will impact a bank's share price…

Colin

Okay, so it's pretty clear that the challenge shouldn't be under-estimated, but if I go back and look at what we've got so far – what we've been through is the interim and there's fewer strict requirements under IAS 34 on what to disclose, so many of the banks had more flexibility on what disclosures to make and we saw variations. Many banks found it hard to obtain even that limited data to prepare those disclosures at interim.

May Tiem

It's clear that the level of effort required for year-end disclosures is going to be much greater, not just because of the mandatory IFRS 9 'business as usual' disclosures, but also because of the heightened expectations of regulators, analysts and investors.

Banks will need to go the extra mile to meet these high expectations and this presents challenges for banks.

The **first** is that regulators, investors and analysts are expecting to see detailed disclosures on the impact of ECL. Banks are likely to find this challenging: mainly because it may be difficult to generate the data for the disclosures but also due to new judgements introduced by IFRS 9, such as macroeconomic forecasts…

Colin

Yes. The **second** key challenge is going to be comparability. Analysts are going to be busier than usual benchmarking and comparing because it's the first time they've seen that information and they are going to be looking for detailed explanations.

If you're an outlier compared to your peers, you'll need to be prepared to answer some searching questions when you go to market with your results: Why are we out of line? Are our valuation models right? What can we learn by benchmarking ourselves against other banks?

May Tiem

I couldn't agree more. The **third** challenge is clearly articulating how you manage your credit risk.

Consider the scenario that two separate banks both issue the same type of loan to customers of the same credit quality in the same market. One is more prudent and sets more conservative staging criteria; the other is less so. The only way users can differentiate is by comparing the banks' staging and current criteria – key risk parameters such as PD, LGD, expected life assumptions and ECL sensitivity to changes in key macroeconomic variables, and assumptions of forecast of future economic conditions.

Without a clear explanation of ECL policies and methodology, there's a risk that users will misinterpret how the bank manages its credit risk, which could have adverse consequences – for example, impacting analysts' decisions.

Colin

I think that's a good point to flag the work of the UK Taskforce for Disclosures on Expected Credit Losses, or DECL, as it's known. Put simply, that's a group of users and investors together with preparers and regulators with the aim to take what has been carved in stone in the financial accounting standards and then enhance it with what those investors actually want to see in the year-end financial statements.

It expects to issue a report in the next month or so with its draft principles for ECL disclosures that should be included, and it's expected the seven largest UK banks will comply. But it's also likely that the findings will quickly become best practice for the banking industry.

May Tiem

The **final** challenge, really, stems from the fact that the IFRS 9 capital transition arrangements allow European banks to spread the first-year retained earnings impact of transitioning to IFRS 9. This is seen by many investors and analysts as a 'let-off', and they will be looking closely at the fully loaded capital impact. European law requires this to be disclosed.

So it's not just about compliance with IFRS 9, which is challenging enough on its own – there's also an added pressure to go the extra mile and meet the enhanced demands of investors.

Colin

That's right, May Tiem. I think banks are going to find it challenging to meet that enhanced demand.

But I think one thing that's also worth highlighting is the idea that modelling expected credit losses can deal with all the future macroeconomics is a false one and most banks acknowledge now that there's no way they can model that no matter how good they are. There's always going to be idiosyncrasies that they can't model or predict…

May Tiem

This brings us quite neatly onto the fact that on top of all this we're undergoing a period of uncertainty that banks will have a tough job to navigate.

Colin

Absolutely true. Take Brexit. The December year-end financial statements are going to be signed off, roughly speaking, at the beginning of February, for the profit announcements, but the UK leaves the European Union (EU) on 29 March.

So why is that important? Well, the economic forecasts for the expected credit losses are predicated on the view of the future as at the year end. And who knows what that will be? Banks will have to make a preliminary announcement before the UK leaves the EU, which will be tricky.

May Tiem

Colin, you mentioned DECL earlier, but another big change coming up – some say with an even bigger accounting impact than Brexit – is the LIBOR replacement programme. Basically, all LIBOR is to be discontinued from 2021 – that's sterling LIBOR and US dollar LIBOR. There are many related accounting issues, covering hedge accounting, valuation and more – all of which will kick in over the next two to three years.

This will be a huge project… Expect to hear more soon.

Colin

Thanks, May Tiem. Well, altogether this points to an exceptionally tough year end for banks, and it's going to be crucial to get the reporting right to mitigate the many risks faced.

To sum up on IFRS 9:

- getting those disclosures right and telling the right story is going to be absolutely critical; and
- understanding and meeting the needs and demands of stakeholders needs to be the real priority for banks.

May Tiem

Definitely. But, over and above this, banks also need to be careful they give the right attention to the other two standards: IFRSs 15 and 16…

A lot of work still needs to be done on revenue disclosures.

And the impact of IFRS 16 needs to be covered in your year-end IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* disclosure.

Host

Thank you, May Tiem and Colin…

For a one-page overview of all the challenges facing banks just covered, take a look at our **pdf episode summary** which you can download from the web article page for this podcast.

Finally, thank you all very much for taking the time to listen to our podcast. And look out for our next episode, which will be released in the coming weeks.