

The Bank Statement

IFRS – Global Banking Newsletter

“The methodologies applied to date to price and reserve for KVA have a long way to go before they are comprehensive even for a given institution, let alone consistent across markets.”

– Colin Martin
KPMG in the UK

KVA – Adjustments for regulatory capital costs

Welcome to the Q4 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

The European Commission has endorsed IFRS 9 *Financial Instruments* – see [page 2](#).

KVA – Demystifying adjustments for the cost of regulatory capital

We delve deeper into the detail around adjustments for the cost of regulatory capital – see [page 9](#).

How do you compare? Fair value disclosures

We look at fair value disclosures for financial instruments that are measured at amortised cost in banks’ financial statements – see [page 14](#).

Regulation in action – Regulatory treatment of accounting provisions

This article discusses the Basel Committee on Banking Supervision’s proposals on the regulatory treatment of accounting provisions – see [page 17](#).

Spotlight on IFRS 9

The EU's endorsement of IFRS 9 has been published.

EU endorses IFRS 9

The European Commission's endorsement of IFRS 9 *Financial Instruments* has been published in the *Official Journal of the European Union* under [Commission Regulation \(EU\) 2016/2067](#) of 22 November 2016.

EBA's impact assessment of IFRS 9

The European Banking Authority's (EBA) first [report on the results of its impact assessment of IFRS 9](#) was published on 10 November 2016. The EBA surveyed 58 banks across the EU, of different size, business model and risk profile, to help it understand the impact of IFRS 9 and the interaction between IFRS 9 and prudential requirements.

When the survey was conducted in April 2016, banks were at an early stage of preparation for the implementation of IFRS 9 and the information provided reflects this. The findings included the following.

- The smaller banks are lagging behind in their preparation.
- There is limited involvement from key stakeholders.
- Banks are generally looking to leverage existing definitions, processes and systems.
- Data quality and availability are the most significant challenges.
- The impact of the new classification and measurement requirements does not seem very significant for most banks, but the new impairment requirements present many challenges.

The EBA noted that it intends to continue monitoring the impact of IFRS 9, and in November 2016 launched [a second impact assessment](#). The sample of participating banks is very similar to the previous one. This second assessment is expected to be completed in February 2017.

ECB launches a thematic review of IFRS 9 implementation

The European Central Bank (ECB) has launched a thematic review of the implementation of IFRS 9, with the objective of assessing banks' preparations for IFRS 9 and estimating the impact on own funds, and to confirm harmonised implementation of the standard. The review is expected to be finalised by mid-2017, but at this stage it is too early to estimate exactly when the ECB will publish its observations.

ESMA issues public statement on implementation issues for IFRS 9

On 10 November 2016, the European Securities and Markets Authority (ESMA) published a public statement, [Issues for consideration in implementing IFRS 9 Financial Instruments](#). It highlights the need for consistent and high-quality implementation and the need for transparency about IFRS 9's impact to users of financial statements.

ESMA notes that IFRS requires disclosure of known or reasonably estimable information – both qualitative and quantitative – relevant to assessing the possible impact of applying a new standard. It believes that the timing of providing disclosures is likely to vary between issuers, depending on the complexity of the implementation process, the impact and the project timetable.

The table below contains ESMA's examples of good practices regarding timing of the disclosures for financial sector institutions.

Timing	Nature of the information
2016 annual financial statements	<ul style="list-style-type: none"> – Detailed qualitative information on how key IFRS 9 concepts will be implemented – Explanation of timeline – If known or reasonably estimable, reliable quantification of the possible impact – When quantitative information is not disclosed, additional qualitative information to indicate the magnitude of the expected impact
2017 interim financial statements	<ul style="list-style-type: none"> – Consider providing updates to the information disclosed in 2016 annual financial statements if there are any significant changes – Consider providing quantitative information, or updates to quantitative information previously released – Explanation of impact of IFRS 9 on key regulatory ratios is encouraged
2017 annual financial statements	<ul style="list-style-type: none"> – Quantitative assessment of the impact as of 1 January 2018 – Explanation of the changes to the amounts reported under IAS 39 <i>Financial Instruments: Recognition and Measurement</i> – Impact on regulatory requirements – Update on information previously provided
2018 annual financial statements	<ul style="list-style-type: none"> – The latest point by which the disclosures in paragraphs 42I to 42S of IFRS 7 <i>Financial Instruments: Disclosures</i> need to be provided

ESMA states that, together with national competent authorities, it will monitor the level of transparency that preparers provide in their financial statements about the implementation of IFRS 9.

IFRS 9 is being reflected in FINREP

In November 2016, the EBA published its [final draft implementing technical standards](#) on supervisory reporting of institutions with regard to financial reporting (FINREP). The draft makes changes to the templates used by banks for regulatory reporting to reflect the requirements of IFRS 9 and to address other issues identified. The draft will be submitted to the European Commission for endorsement before being published in the *Official Journal of the European Union*.

Changes to FINREP templates

The changes resulting from the new requirements in IFRS 9 include:

- *classification and measurement*: removal of the IAS 39 categories and introduction of IFRS 9 categories for financial assets;
- *impairment*: information on impairment stages, use of rebuttable presumptions, credit-impaired assets, write-offs, loss allowances, modifications and interest income on impaired assets; and
- *hedge accounting*: aligning the templates with the amended requirements
 - e.g. the fair value option to hedge credit risk or use of non-derivative hedging instruments.

Some of the other changes that result from requests received by the EBA in the consultation and issues previously identified also relate to the requirements of IFRS 9. For example, these include:

- guidance on reporting the gross carrying amount where a new FINREP definition is inserted, building on the one in IFRS 9;
- non-performing exposures and forbearance; and
- reporting of investments in associates, subsidiaries and joint ventures.

Implementation date

The first reporting reference date will follow the first application date of the EU-endorsed IFRS 9 for each institution. For example, if an institution has a calendar year end, then its first application date will be 1 January 2018, with a first reference date of 31 March 2018.

IASB activities affecting your bank

The IFRS Interpretations Committee will develop an interpretation to explain the accounting for certain modifications and exchanges.

IFRS 9 – Modification or exchange of financial liabilities that do not result in derecognition

In November 2016, the IFRS Interpretations Committee discussed whether an entity recognises a gain or loss in profit or loss in respect of a financial liability that is modified or exchanged and for which the modification or exchange does not result in derecognition of the financial liability.

The Committee concluded that the requirements in paragraph B5.4.6 of IFRS 9 apply to all revisions of estimated payments or receipts that do not result in derecognition of the financial liability, including changes in cash flows arising from modifications or exchanges of financial liabilities. The Committee noted that this is consistent with the requirements in paragraph 5.4.3 of IFRS 9 on the modification of financial assets and the definition of amortised cost in Appendix A of IFRS 9.

The Committee concluded that, under paragraph B5.4.6 of IFRS 9, an entity recalculates the amortised cost of the modified financial liability by discounting the modified contractual cash flows using the original effective interest rate. The entity recognises any resulting adjustment to the amortised cost of the financial liability in profit or loss as income or expense at the date of the modification or exchange.

The Committee tentatively decided to develop a draft interpretation to explain the accounting for such modifications and exchanges.

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

In November 2016, the IFRS Interpretations Committee continued its discussion on which fees and costs to include in the '10 percent' test for the purposes of derecognition of a financial liability.

Previously, the Committee had concluded that, when applying paragraphs B3.3.6 of IFRS 9 and AG62 of IAS 39 in carrying out the 10 percent test, an entity includes only fees paid or received between the entity and the lender, including fees paid or received by either the entity or the lender on the other's behalf. At the November 2016 meeting, the Committee recommended that the Board propose an amendment to clarify the requirements as part of the next annual improvements cycle.

Commodity loans

In November 2016, the IFRS Interpretations Committee discussed how to account for a commodity loan transaction in which a bank borrows gold from a third party (Contract 1) and then lends that gold to a different third party for the same term and for a higher fee (Contract 2). The bank enters into the two contracts in contemplation of each other, but the contracts are not linked – i.e. the bank negotiates the contracts independently of each other. In each contract, the borrower obtains legal title to the gold at inception and at the end of the contract it has an obligation to return gold of the same quality and quantity as that received. In exchange for the loan of gold, each borrower pays a fee to the respective lender over the term of the contract, but there are no cash flows at inception of the contract.

The Committee was asked whether the bank that borrows and then lends the gold recognises:

- an asset representing the gold (or the right to receive gold); and
- a liability representing the obligation to deliver gold.

The Committee concluded that it would be unable to resolve the question efficiently within the confines of existing IFRS. The wide range of transactions involving commodities means that any narrow-scope standard-setting activity would be of limited benefit to entities and would have a high risk of unintended consequences. Consequently, the Committee tentatively decided not to add this issue to its agenda.

IAS 28 – Fund manager’s assessment of significant influence

In November 2016, the IFRS Interpretations Committee discussed whether and, if so, how a fund manager assesses significant influence over a fund that it manages and in which it has an investment. In the scenario considered, the fund manager applies IFRS 10 *Consolidated Financial Statements* and determines that it is an agent, and therefore does not control the fund. The fund manager has also concluded that it does not have joint control of the fund.

The Committee observed that a fund manager assesses whether it has control, joint control or significant influence over a fund that it manages by applying the relevant standard, which in the case of significant influence is IAS 28 *Investments in Associates and Joint Ventures*. The Committee noted that, unlike IFRS 10, IAS 28 does not discuss whether and how decision-making authority held in the capacity of an agent affects the assessment of significant influence. Developing any such requirements could not be undertaken in isolation, without a comprehensive review of the definition of significant influence in IAS 28.

The Committee concluded that it would be unable to resolve the question efficiently within the confines of existing IFRS and tentatively decided not to add the issue to its agenda.

IFRS 10 – Investment entities and subsidiaries

In November 2016, the IFRS Interpretations Committee discussed the investment entity requirements in IFRS 10, including how an investment entity assesses whether it consolidates a subsidiary under paragraph 32 in certain circumstances. The Committee discussed:

- whether an entity qualifies as an investment entity if it possesses all three of the elements described in paragraph 27 of IFRS 10 but does not have one or more of the typical characteristics of an investment entity included in paragraph 28;
- whether an entity provides investment management services to investors (under paragraph 27(a) of IFRS 10) if it outsources the performance of these services to a third party;
- whether a subsidiary provides services that relate to its parent investment entity’s investment (under paragraph 32 of IFRS 10) by holding an investment portfolio as the beneficial owner; and
- to what extent an investment entity can provide investment-related services, itself or through a subsidiary, to third parties.

For all four questions, the Committee provided feedback and concluded that the principles and requirements under IFRS provide a sufficient basis to enable an entity to determine the appropriate accounting in each of the specified circumstances and tentatively decided not to add this issue to its agenda.

IAS 32 – Written put options over non-controlling interests to be settled by a variable number of the parent’s shares

In November 2016, the IFRS Interpretations Committee discussed how an entity accounts for a written put option over non-controlling interests (NCI put) in its consolidated financial statements. The NCI put’s strike price will, or may, be settled by the exchange of a variable number of the parent’s own equity instruments.

Specifically, the Committee was asked to consider whether the entity:

- recognises a gross financial liability representing the present value of the option’s strike price (paragraph 23 of IAS 32 *Financial Instruments: Presentation*); or
- recognises a derivative financial liability.

The Committee was also asked whether the entity applies the same accounting where it has the choice to settle the exercise price either in cash or by way of a variable number of its own equity instruments to the same value.

The Committee observed that it had previously discussed issues relating to cash-settled NCI puts. The Committee also noted that the issue is too broad to address efficiently and the Board is currently considering the requirements for all derivatives on an entity’s own equity as part of the financial instruments with characteristics of equity project.

For these reasons, the Committee decided not to add this issue to its agenda.

IFRS 9 – Effect of symmetric ‘make-whole’ and fair value prepayment options on the assessment of the SPPI condition

In December 2016, the Board considered the recommendation from the IFRS Interpretations Committee to add to its agenda a narrow-scope project on IFRS 9 on symmetric ‘make-whole’ prepayment options included in financial assets.

In its November 2016 meeting, the IFRS Interpretations Committee had considered whether a debt instrument could have contractual cash flows that meet the solely payments of principal and interest (SPPI) criterion if the contractual terms of the instrument include a symmetric make-whole prepayment option or a fair value prepayment option. Most Committee members considered that the prepayment options do not meet the requirements in paragraph B4.1.11(b) of IFRS 9 and, therefore, a debt instrument with such a contractual provision does not meet the IFRS 9 SPPI requirements.

The Board agreed to add a narrow-scope project on IFRS 9 on symmetric make-whole prepayment options included in financial assets and will discuss this in its January 2017 meeting.

IFRS 5 Non-current Assets Held for Sale and IFRS 9 – Application of IFRS 9 to transactions of a subsidiary when the subsidiary is held for sale

In November 2016, the IFRS Interpretations Committee discussed the impact, in consolidated financial statements, on cash flow hedge accounting and the business model assessment under IFRS 9 of a subsidiary held for sale. The Committee members were of the view that, in its consolidated financial statements, an entity assesses the relevant requirements of IFRS 9 from the group perspective. Accordingly:

- an entity discontinues cash flow hedge accounting for forecast transactions when the forecast transactions are no longer highly probable from the group perspective; and
- an entity assesses its business model for the purpose of classifying financial assets from the group perspective.

The Committee members also noted that the question regarding cash flow hedge accounting is relevant under IAS 39 and suggested that outreach be carried out to understand if there is diversity in practice.

Post-implementation review of IFRS 13

The Board is currently undertaking a post-implementation review of IFRS 13 *Fair Value Measurement*. In [November 2016](#), the IFRS Interpretations Committee discussed some of the feedback received from stakeholders and provided input to the Board's discussions.

Financial instruments with characteristics of equity

The Board discussed the project at each of its monthly meetings during the last quarter, focusing on the following topics:

- *October 2016*: claims where the issuing entity can choose between alternative settlement outcomes, considering whether economic incentives should affect the classification;
- *November 2016*: the classification under the [Gamma approach](#) of instruments meeting the existing puttables exception in IAS 32 and the merits of retaining the exception; and
- *December 2016*: the application of the Gamma approach to derivatives on own equity – in particular, some common issues that arise in practice when applying the fixed-for-fixed condition in IAS 32.

The next steps will be to consider:

- the substance of rights and obligations in contracts and their interaction with legal and regulatory requirements; and
- recognition, derecognition and reclassification of equity instruments.

For more information, see our *IFRS Newsletter: Financial Instruments* for [October](#), [November](#) and [December 2016](#).

KVA – Demystifying adjustments for the cost of regulatory capital

“The ultimate test of a KVA is whether it genuinely reflects the price at which a willing counterparty would enter into a transaction.”

– Colin Martin
KPMG in the UK

Portfolio valuation adjustments for derivative portfolios have become increasingly sophisticated over recent years. Amounts arising from credit risk (credit valuation adjustments or CVA), from own credit risk (debit valuation adjustments or DVA), from funding (funding valuation adjustments or FVA) and bid/offer adjustments are all commonly recognised when valuing derivatives using mid-market yield curves and inputs. One of the newest and potentially largest adjustments to come under consideration is for the cost of regulatory capital – so-called KVA. This article delves deeper into the detail of KVA.

Understanding KVA – The basics

The underlying principle of KVA is a valuation adjustment to reflect the cost of holding regulatory capital against derivatives over the life of the portfolio. As regulatory rules have evolved – e.g. the introduction of leverage ratios and regulatory floors – regulatory capital requirements for counterparty risk have increased considerably, especially for long-dated over-the-counter (OTC) derivative contracts. As a consequence, the returns on regulatory capital employed for derivative activities have decreased in recent times.

To address this, when pricing contracts, many derivatives traders consider expectations about the cost of regulatory capital in maintaining the position over the life of a specific trade, therefore effectively charging an additional number of basis points as a spread on that trade. This pricing practice is starting to be applied to more derivative instruments than has previously been the case.

In theory, if all market participants had the same view of the costs of regulatory capital, then the additional spread charged would be ‘on market’ and discount rates for derivatives would be adjusted for the increased costs (similar to how the discount rate of a single counterparty would be the same if the whole market held the same view of its creditworthiness). However, because this is not the case, individual derivatives are valued on mid-market curves that do not include any element of regulatory capital cost, and a portfolio KVA adjustment can be raised to ensure that the KVA spreads included by traders are not recognised as profit on day one.

For those derivatives that have an increased spread included in the transaction price, the KVA adjustment has the effect of deferring the spread over the life of the deal, in the same way that CVA defers any unearned credit spread on a particular deal (see the ‘front book’ discussion below). For those derivatives where no spread was charged because the deal was executed some years ago, before the regulatory capital requirements of derivative activities had risen so substantially (see the ‘back book’ discussion below), any booked KVA adjustment would have the effect of reducing the overall value of a portfolio of derivatives. This effectively represents the discount that market participants would place on the opportunity costs of setting aside sufficient regulatory capital to hold the derivative portfolio.

Practical challenges

A hypothesis for recognising KVA implicitly assumes that the fair value that an arm’s length counterparty would pay for an asset or a portfolio of assets would include a KVA adjustment calculated in the same way as the calculation of a KVA performed by the entity. However, although the theory behind the KVA calculation sounds simple, there are a number of practical reasons why the calculation of a KVA spread would not be replicated by an arm’s length counterparty. It is these challenges that an entity has to overcome when asserting that a KVA calculation based on its own circumstances is a proxy for the calculation that an arm’s length counterparty would perform.

These are as follows.

<p>Differences in the way regulatory capital is calculated</p>	<p>There are numerous ways in which a market participant may calculate its capital requirement, depending on approvals from its local regulator. These range from standardised credit and simple market risk calculations to advanced internal ratings-based (AIRB) counterparty risk calculations and trading book value-at-risk (VaR) metrics. The result is a bespoke capital calculation that is very likely to be specific to the entity. It is unlikely that a counterparty would calculate the same capital requirement for a given trade and therefore be willing to pay, in an arm's length transaction, the fair value calculated by the entity that includes the entity's estimate of KVA.</p>
<p>Differences in the way regulatory netting sets apply</p>	<p>Regulatory netting sets – i.e. regulatory netting requirements for transactions with a single counterparty subject to a legally enforceable bilateral netting arrangement – are specific to a given entity. For example, consider two entities each with one long and one short swap position. If one of the entities qualifies for regulatory netting of its two swap positions and the other does not, then they will have different capital requirements for the offsetting positions. KVA calculations implicitly assume that the netting sets of arm's length buyers and sellers are the same as those of the calculating entity, which is generally not the case.</p>
<p>Incremental nature of cost of regulatory capital</p>	<p>The addition of a derivative to a book of existing derivatives is an increment to the existing portfolio. For entities that qualify for regulatory netting, entering into an offsetting derivative actually reduces its counterparty charge. The incremental effect is in reality a negative cost of regulatory capital. To accurately price the cost of regulatory capital for a single derivative, an entity would require a real-time, incremental calculator that factors in all other regulatory capital calculations, netting etc before coming up with a spread. Such complex calculations have not yet been attempted by banks.</p>
<p>Business model and regulatory status</p>	<p>Different quantities of capital may be required for the same portfolio depending on the institution's regulatory status and its interpretation of those regulations. The capital requirements also change depending on the intention of the institution. For example, derivatives included in the 'banking book' for regulatory purposes may have different capital requirements from derivatives included in the 'trading book' for regulatory purposes.</p>

Lifetime capital costs	Lifetime capital costs are required, rather than just the spot capital costs, based on the current regulatory requirements, when calculating a KVA. This would require the bank to anticipate future changes and potential future changes to regulatory capital calculations.
Cost of capital	The cost of capital is an internal parameter and represents the percentage return on regulatory capital that is required by shareholders in response to their decision to deploy this capital in support of derivative trading activities.
Future changes to the instrument	To accurately price KVA, assumptions have to be made about whether the derivative will be extant in its current state potentially many years in the future. For example, a portfolio of 20-year derivatives that does not remain on the trading book for more than five years would not require capital for 20 years. Changes in collateral terms over its life could also change the regulatory capital requirements.

In addition to the calculation itself, there are two distinct parts of the trading book that are likely to require different analyses when considering KVA.

The front book

For the purposes of KVA, this is the derivative positions of the entity where the dealers have considered regulatory capital costs and set a price according to their calculations.

This is not necessarily the most recent trades undertaken, although it is most likely to be in many instances. Some products have traditionally been associated with large risk-weighted asset calculations, such that they are more regulatory capital heavy. For such trades, the dealer would often charge an extra spread for the use of capital. By undertaking the transaction, the trading desk would use up its capital limits such that to maintain a consistent return on risk-weighted assets, it would have to charge accordingly. A good example is long-dated inflation swaps, which would typically have had their own, specific calculation of a regulatory capital reserve to adjust for this effect.

The effect of a KVA reserve for this part of the book is to neutralise the spreads added that would otherwise have been recognised as profit on day one. The argument for a reserve against this portion of the book is stronger, although still difficult to calculate.

The back book

For the purposes of KVA, this is the derivative positions of the entity where the dealers have not considered regulatory capital costs and have not added a specific spread according to their calculations.

These trades are typically older derivatives, originated when systems and pricing were simpler. Although these positions have not had a spread specifically added for cost of capital, they may still contain an element that implicitly covers regulatory capital costs. For example, if the bank set a minimum rate of return – i.e. a hurdle rate – then it is likely that this hurdle rate had some consideration for the overall

Some of the issues to consider relate to determining the appropriate unit of account to which a KVA is applied, the allocation of a KVA and the observability of KVA inputs.

return on capital built into it. However, that methodology may mean that it is difficult to differentiate between similar trades that exceed the hurdle rate. For example, consider two trades executed against a hurdle rate of 20bps, which both trades just exceed. A highly profitable trade with an explicit regulatory capital spread of 15bps may be difficult to tell apart from a trade with low profitability and regulatory capital spread of 5bps.

Some accounting considerations

From an accounting perspective, some of the issues to consider relate to determining the appropriate unit of account to which a KVA is applied, the allocation of a KVA and the observability of KVA inputs.

Unit of account – Portfolio-level considerations

Providing certain conditions are met, IFRS 13 allows entities to measure the fair value of a portfolio of financial assets or financial liabilities on the basis of their net exposure to either market risk or credit risk. 'Market risk' includes interest rate risk, currency risk and other price risk. 'Other price risk' is the risk that the fair value of a financial instrument will fluctuate because of changes in market prices other than those arising from interest rate risk or currency risk, irrespective of whether those changes are caused by factors specific to the individual financial instrument or its issuer or by factors affecting all similar financial instruments traded in the market.

Therefore, a KVA can be viewed as an example of other price risk and therefore a market risk under IFRS 13 that is eligible to be calculated on a portfolio basis provided that it can be shown to impact market prices and the other relevant IFRS 13 criteria are met.

Allocation of KVA to individual instruments

IFRS 13 requires portfolio-level adjustments to be allocated to the individual contracts that make up the portfolio. An entity has to perform the allocation on a reasonable and consistent basis using an appropriate methodology.

This is difficult to do when KVA is incremental to the existing positions in the derivatives book. For example, in the trading book VaR metric, correlations between positions are taken into account. It is therefore possible to add derivatives (e.g. an equity option) to a portfolio with dissimilar risks to that derivative (e.g. interest rate swaps) and reduce the overall VaR for that portfolio. As a result, the equity option would have a negative capital impact for market risk. This situation would persist only until the portfolio position or the correlation changes, which makes any mechanism of allocation a difficult proposition.

Observability considerations

If the extra spread included in pricing by the trader is not reflected in the valuation for accounting purposes, then this would result in the extra spread being recognised as profit on day one. So by not performing the KVA calculation when the cost of regulatory capital has been added, the entity generates a day one profit or loss.

Alternatively, the entity might perform a portfolio-level KVA calculation for accounting purposes. As noted above, the reason the calculation can be undertaken on a portfolio basis under IFRS 13 is that the regulatory capital on which the calculation is based is a type of market risk. However, the entity is required to develop unobservable inputs using the best information available in the circumstances. In the case of a KVA, this may begin with the entity using its own regulatory costs of capital for holding the derivative and adjusting that data in line

with other reasonably available market information. As an unobservable valuation input, if a KVA is significant to the trade or portfolio, then the day one profit or loss that remains after the KVA has been reserved would be deferred.

For the back book, where the cost of regulatory capital has not been specifically priced into contracts, a KVA calculated using today's assumptions (and reflecting the increase in trading book capital requirements that has occurred since the 2008 financial crisis) would be a loss recognised in profit or loss. It is doubtful that any (older) hurdle rate pricing method applied by the front office at the inception of the trade would have been calibrated to deal with the subsequent increases in capital needed to maintain a trading book since 2008.

Current practice

The practice of pricing KVA is not yet widespread and it depends on the type of derivative. Furthermore, because of its complexity, there is no specific KVA methodology that has developed into a dominant current market practice.

The use of KVA for some derivative portfolios, especially by the most sophisticated entities, is generally considered acceptable market practice, although this has not developed to a point where KVA is considered to be a requirement for all such entities. However, as processes develop across the market this is likely to change, as has been the case with other portfolio valuation adjustments – e.g. CVA and DVA.

As an exception, certain individual capital-intensive trades (e.g. long-dated inflation swaps) routinely have a specific KVA calculated and included in banks' models. In these cases, the reserving of KVA is much more widely accepted and, in some cases, it may be consistently observable in prices quoted.

Uncharted territory

There has always been a cost of regulatory capital associated with trading derivative positions. However, the methodologies applied to date to price and reserve for it have a long way to go before they are comprehensive even for a given institution, let alone consistent across markets.

As result, application of KVA appears to be sporadic even among the largest, most sophisticated institutions. The ultimate test of a KVA is whether it genuinely reflects the price at which a willing counterparty would enter into a transaction.

Uncollateralised OTC contracts are the main source of regulatory capital cost to banks, unlike large interbank contracts, which are subject to collateralisation and netting that substantially reduces the capital cost. However, OTC derivatives are not transferred between entities with sufficient frequency to regularly back-test the calculations. In addition, there is always the possibility – especially for smaller portfolios where the portfolio effect is not as strong – that the regulatory cost of capital to one institution is entirely different from another's, such that the price between willing buyer and willing seller is entirely different even if both employ a sophisticated KVA calculation.

Although it is clear that traders are starting to price for KVA, albeit in a simplistic way, consistency of methodology is still lacking. As the market develops and more sophisticated approaches are devised, this may change.

How do you compare? Fair value disclosures

All of the banks provided tabular disclosures that compared the carrying amounts and fair values.

In this issue, we look at fair value disclosures for financial instruments that are measured at amortised cost in banks' financial statements.

What are the disclosure requirements?

IFRS 7 requires banks to disclose the fair value for each class of financial assets and financial liabilities, with certain exemptions. One of the exemptions is when the carrying amount is a reasonable approximation of fair value.

IFRS 13 requires entities to disclose, for financial assets and financial liabilities not measured at fair value but for which the fair value is disclosed, the level of the fair value hierarchy within which the fair value measurements are categorised. As a reminder, the fair value hierarchy is made up of three levels:

- *Level 1 inputs*: unadjusted quoted prices in active markets for identical assets or liabilities that the entity can access at the measurement date;
- *Level 2 inputs*: inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices); and
- *Level 3 inputs*: unobservable inputs for the asset or liability.

Our sample

Our sample consisted of 10 large international banks' December 2015 annual financial statements. We looked at disclosures relating to loans and advances to customers and banks, and deposits from customers and banks.

Comparisons of carrying value and fair value

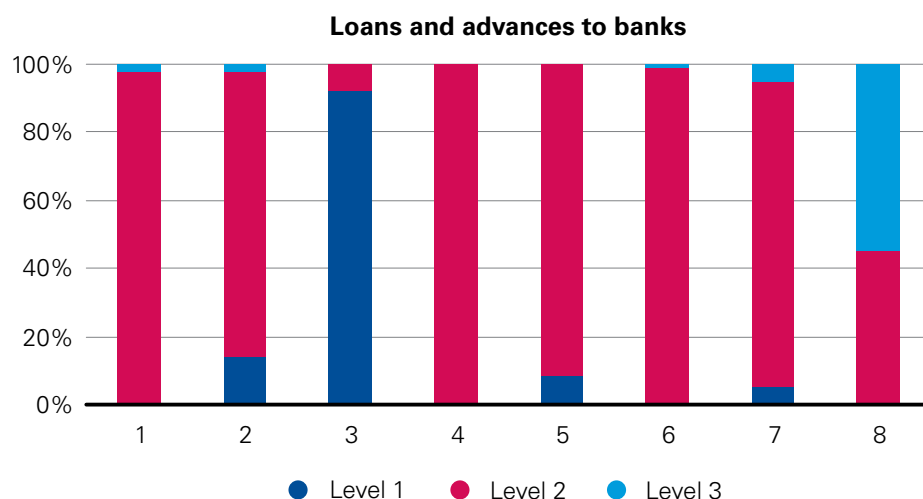
All of the banks provided tabular disclosures that compared the carrying amounts and fair values and levels of fair value hierarchy for those instruments, except one bank that did not provide fair value hierarchy disclosures for floating-rate financial instruments whose carrying amount approximated fair value.

Fair value hierarchy categorisation

Loans and advances to banks

Most of the banks classified the majority of their loans and advances to banks within Level 2 of the fair value hierarchy. Some noted that the fair value measurement for most of these loans and advances was based on observable market transactions and other inputs derived from observable data.

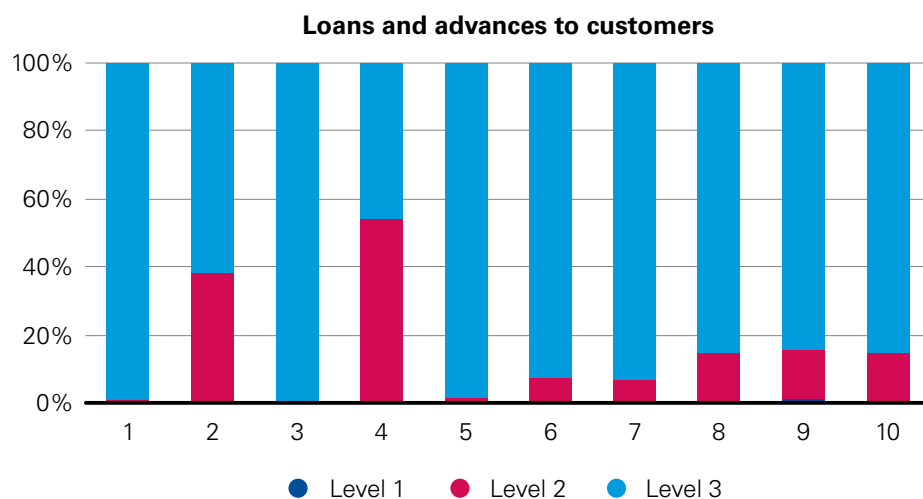
One bank categorised over 90 percent within Level 1 but it described the captions as 'Amounts due from banks' without providing further detail and so it could be that it contains assets other than loans. Another bank categorised about 55 percent within Level 3. The graph below illustrates the disclosures provided by eight banks.¹



Loans and advances to customers

In contrast to loans and advances to banks, the majority of loans and advances to customers were classified within Level 3. A few banks noted that market prices were unavailable for most loans and advances to customers, because they were generally not traded in organised markets, so the fair value measurement was based on valuation techniques using unobservable inputs.

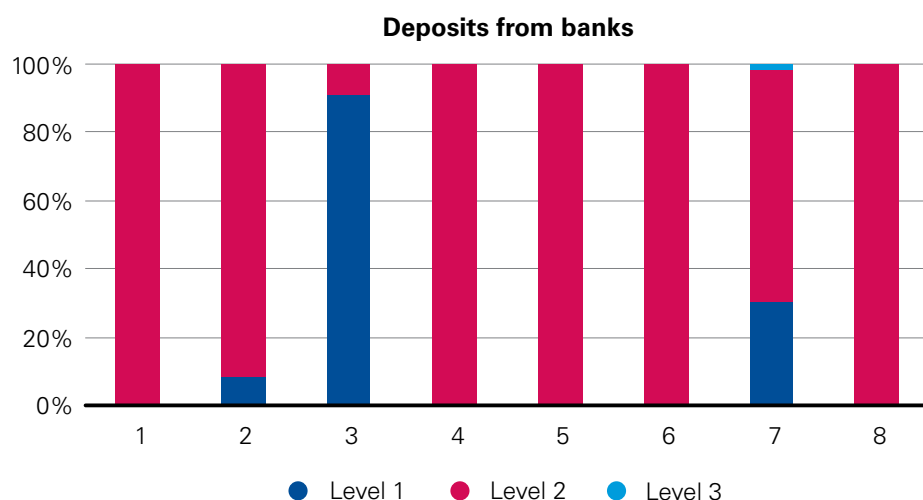
One bank categorised about 55 percent of its loans and advances to customers within Level 2, with the remainder classified within Level 3. Level 1 categorisation was generally not used. The graph below illustrates the disclosures.



1. Two of the banks sampled made disclosures for all loans and advances together, without further analysis between customers and banks. It appears that these were mainly loans and advances to customers, so they have been included in the graph illustrating loans and advances customers.

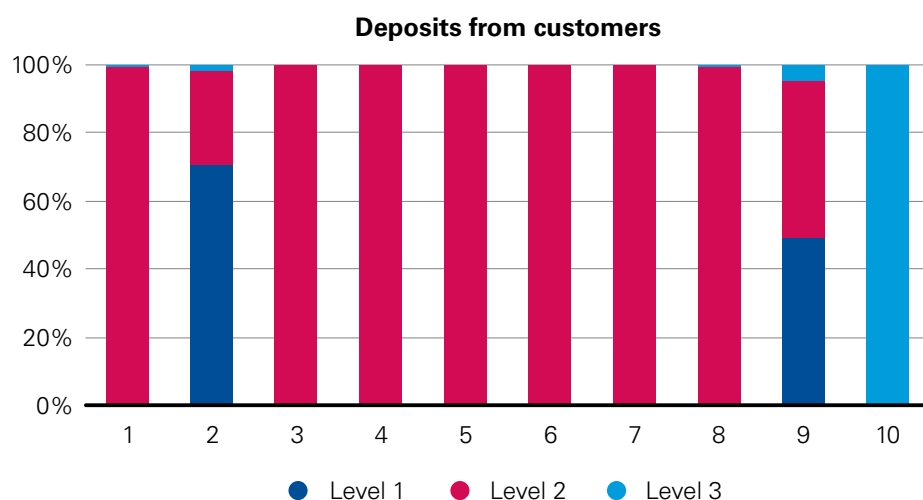
Deposits from banks

Most of the banks categorised the majority of deposits from banks within Level 2 and noted that, in many cases, the fair values of these deposits were similar to the carrying values due to their short-term nature. One bank categorised about 90 percent within Level 1, although this amount was made up of both debt funding and deposits from banks and further detail was not provided. The graph below illustrates the disclosures for eight banks.²



Deposits from customers

Similarly to deposits from banks, most of the banks in our sample categorised the majority of deposits from customers within Level 2. However, one bank categorised all deposits from customers within Level 3. There were also two banks that classified about 50 to 70 percent of their deposits from customers within Level 1. The graph below illustrates the disclosures.



2. Two of the banks sampled provided disclosures for all deposits without further detail, although it appears that these were mainly deposits from customers and so they have been included in the graph illustrating deposits from customers.

Regulation in action – Regulatory treatment of accounting provisions

“This is the start of a journey on the interaction between the regulatory capital regime and the new IFRS 9 accounting standard.”

– **Steven Hall**
KPMG in the UK

In October 2016, the Basel Committee on Banking Supervision published both a [consultation paper](#) and a [discussion paper](#) on the regulatory treatment of accounting provisions. Both deal with how the upcoming IFRS 9 regime interacts with the Basel regulatory capital requirements for banks.

The Basel Committee addresses two key elements in the two papers.

- *Short-term response*: The move to expected credit loss (ECL) accounting is widely expected to increase the overall amount of provisions that banks will have to recognise on their balance sheets, although the level of increase is not yet known with any accuracy because most firms are still in their implementation phases. This increase in provisions is likely to reduce the capital ratios of banks (see below) and therefore, in the consultation paper, the Basel Committee is proposing transitional arrangements under which the ‘capital shock’ is phased in over a period of three to five years.
- *Long-term response*: The current regulatory framework still distinguishes between specific and general provisions, and also has different treatments in the standardised and internal ratings-based (IRB) approaches for how expected losses and provisions are dealt with. The Basel Committee’s discussion paper therefore sets out longer-term mechanisms for how the Basel capital framework could be adapted to reflect the change in accounting.

How are provisions considered in the current regulatory capital regime?

Provisions are currently dealt with differently depending on whether the bank uses the standardised or IRB approach.

- *Standardised approach*: The capital requirement is calculated based on the gross exposure net of specific provisions, and therefore because IFRS 9 is expected to increase the provisions associated with an individual asset the resulting net exposure and so capital requirement will fall. However, this reduction in capital requirements is outweighed by the 1:1 deduction of the increased IFRS 9 provision from capital resources. Only general provisions are allowed to be added back to Tier 2 capital (up to a certain limit). Currently, different national competent authorities determine what should count as general provisions for capital purposes (they need to be capable of absorbing future losses) differently and it is expected that such differences may continue post IFRS 9.
- *IRB approach*: The capital requirement is calculated based on the gross exposure and therefore this is unchanged under IFRS 9. Any shortfall between eligible accounting provisions (essentially specific provisions, partial write-offs and general provisions) and regulatory expected losses is deducted from capital resources and any excess is added back to Tier 2 (up to a certain limit). Depending on the extent to which IFRS 9 provisions increase beyond the regulatory expected loss, we could see an impact on an IRB bank’s capital resources as well (either Tier 1 or total capital).

Consultation paper – Transition arrangements

As set out above, the move to ECL accounting is likely to increase the overall amount of loan loss provisions for many banks, and could reduce significantly some banks' CET1 capital ratios, notably those on the standardised approach. The Basel Committee is therefore proposing transition arrangements under which the capital shock is phased in over a three-to-five-year period.

Options

This might take one of the following forms.

1. Phasing in the full impact of the 'day one shock' over the transition period – an initial upward adjustment to CET1 capital (to compensate for some or all of the shock) would be phased out on a straight-line amortisation basis over the chosen period.
2. Applying an amortisation approach to a percentage of provisions (based on the reduction in CET1 capital when ECL accounting is introduced) multiplied by the stock of provisions at each reporting date during the transition period.
3. Phasing in the recognition of ECL provisions for regulatory purposes over the transition period, taking into account the likely difference between stage 1 and stage 2 provisions under IFRS 9.

The consultation paper sets out the three options and it is clear that the Basel Committee favours option (1), not least because it is the simplest of the three. Whichever option is eventually chosen, banks will welcome the cushioning of the impact of the move to ECL accounting during the transition period. However, in general the industry remains frustrated that the transition period is a transition to an uncertain end state, and therefore some are calling for what they describe as 'full neutralisation', which would represent a full unwinding of the capital shock until such time as the Basel Committee has determined its long-term solution (see below). The Basel Committee has made clear that it doesn't see full neutralisation as an option and that the partial relief is the only way forward. It therefore remains to be seen what mechanism for partial relief will be agreed.

Discussion paper – Longer-term solution

As set out above, the current regulatory treatment of accounting provisions is based on a distinction between specific and general provisions, at least for the standardised approach, whereas ECL accounting does not generate separate calculations of general and specific provisions.

Although there is no such distinction for banks using IRB models, these models may not cover all of a bank's credit exposures. Under the Basel Committee's proposals to introduce a capital floor for banks using IRB models based on the standardised calculations, such banks would also have to calculate what their position would have been under the standardised approach.

Existing incurred loss approaches to provisioning have also given rise to variability in levels of provisions across countries due to the different ways in which they have been implemented by banks and regulators globally. This has led to variability in the allocation of provisions between specific and general provisions, and the Basel Committee is exploring whether there should be greater specification of how this distinction is drawn for regulatory purposes.

Options

In its discussion paper, the Basel Committee sets out a number of longer-term options to address the issues identified above, including:

- a. retaining the current regulatory treatment of provisions, including the distinction between general and specific provisions, at least over a transition period and possibly on a permanent basis – this is likely to be least attractive to the industry, given the capital shock that arises under IFRS 9;
- b. retaining a distinction between general and specific provisions, but based on new universally applicable and binding definitions of general and specific provisions;
- c. removing the distinction between general and specific provisions and introducing a standardised regulatory expected loss (EL) concept under the standardised approach. For example, a standardised EL rate could be set for each risk weight under the standardised approach, based on an implied probability of default and loss given default rates. This EL amount could then serve as the minimum amount of credit losses that regulators would require banks to cover in the form of CET1 reduction under the Pillar 1 capital requirements. Whatever accounting provisions have been made for credit losses, full recognition up to the regulatory EL rates would be given as long as those provisions reduce CET1 capital. This would in effect introduce a regulatory floor for accounting provisions in the context of capital ratio calculations, and provide consistency in a world of diverse provisioning standards; or
- d. developing an alternative approach based on responses to the discussion paper.

Although the Basel Committee does not explicitly express a preference for any of these options, the space devoted to option (c) and the disadvantages noted under options (a) and (b) suggest that option (c) is its preferred approach.

Conclusion

The Basel Committee sees the discussion paper as the start of a journey towards a long-term solution to the interaction between the regulatory capital regime and the new IFRS 9 accounting standard. This puts a further road-block in the way of finalising the Basel 4 requirements and means that whatever is agreed with respect to the standardised credit risk approach and the internal model capital floors at the Governors and Heads of Supervision (GHoS) meeting in January 2017 will need to be revised further in the future.

In the meantime, the consultation paper does propose providing some capital relief if national competent authorities allow it and the impact is considered more material than had previously been expected. It also allows for the different implementation dates between IFRS 9 and the US CECL regime. It remains to be seen whether agreement can be reached on the long-term regime and in the meantime what approach the Basel Committee takes to short-term pain relief.

Where regulation and reporting meet...

The priorities for 2016 financial statements are presentation of performance, financial instruments and disclosure of the impacts of the new standards.

ESMA sets enforcement priorities for 2016 financial statements

In October 2016, ESMA published its annual [public statement on European common enforcement priorities](#), which sets out the areas that ESMA and national enforcers will focus on when they examine listed companies' 2016 financial statements.

The priorities for 2016 financial statements encompass:

- *presentation of financial performance*: issuers should ensure transparency and consistency when presenting their performance in the primary financial statements, notes and documents accompanying financial statements, so that investors are provided with clear and high-quality information;
- *financial instruments*: the distinction between equity instruments and financial liabilities requires significant judgement; and
- *disclosures of the impact of the new standards*: IFRS 9, IFRS 15 *Revenue from Contracts with Customers* and IFRS 16 *Leases*.

In addition, ESMA recommends that issuers potentially affected by the UK's vote to leave the EU assess and disclose the associated risks and expected impacts that it may have on their business activities.

EBA guidelines on the definition of default

On 28 September 2016, the EBA published its final report, [Guidelines on the application of the definition of default](#).³ This is relevant to banks that plan to incorporate the regulatory definition of default in implementing the ECL model in IFRS 9. In general, the EBA proposes that exposures that are treated as credit-impaired under IFRS 9 would be treated as defaulted.

The guidelines have a mandatory application date of 1 January 2021, but the EBA encourages institutions to implement the changes before that date.

Proposals for new EU banking legislation reforms

In November 2016, the European Commission published revisions to the *Capital Requirements Regulation* (CRR) and the *Capital Requirements Directive* (CRD4)⁴. The revisions include proposals similar to those recently issued by the Basel Committee, including phasing in the regulatory implications of IFRS 9's new impairment model (see the 'Regulation in Action' article on [page 17](#)). The phasing-in mirrors one of the options in the Basel proposals but with a longer phasing-in period and the proposed CRR2⁵ text would allow all of the incremental ECL allowances calculated under IFRS 9 to be added back into CET1 capital.

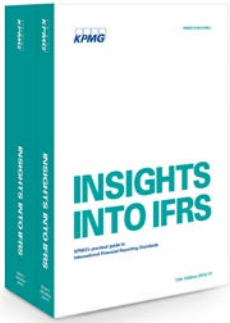
3. Under article 178 of Regulation (EU) No. 575/2013.

4. Proposal for a Regulation of the European Parliament and of the Council – amending Regulation (EU) No. 575/2013 as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements and amending Regulation (EU) No. 648/2012.

5. Amendments to CRR.

You may also be interested to read...

Insights into IFRS: 13th Edition 2016/17



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

September 2016

IFRS Newsletter: Financial Instruments – Issues 33, 34 and 35



Follows the IASB's deliberations on amendments to financial instruments accounting.

October, November and December 2016

First Impressions: Amendments to IFRS 4



Contains insight and analysis to help you assess the potential impact of the amendments on your business.

September 2016

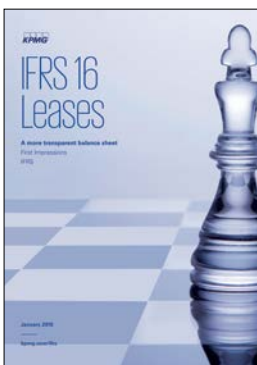
IFRS Newsletter: IFRS 9 Impairment – Issue 3



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

December 2015

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: Insurance – Issue 56



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

November 2016

Click on the images above to access the publications.

Banking contacts

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

Bermuda

Craig Bridgewater

T: +1 441 294 2647

E: craigbridgewater@kpmg.bm

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

Walkman Lee

T: +86 10 8508 7043

E: walkman.lee@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

Dick Korf

T: +31 206 567382

E: korf.dick@kpmg.nl

Portugal

Ines Viegas

T: +31 206 567334

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, Shandhir Lachman and Colin Martin.

Publication name: *The Bank Statement*

Publication number: Issue 24

Publication date: January 2017

© 2017 KPMG IFRG Limited, a UK company, limited by guarantee. All rights reserved.

KPMG International Standards Group is part of KPMG IFRG Limited.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

KPMG International Cooperative ("KPMG International") is a Swiss entity that serves as a coordinating entity for a network of independent firms operating under the KPMG name. KPMG International provides no audit or other client services. Such services are provided solely by member firms of KPMG International (including sublicensees and subsidiaries) in their respective geographic areas. KPMG International and its member firms are legally distinct and separate entities. They are not and nothing contained herein shall be construed to place these entities in the relationship of parents, subsidiaries, agents, partners, or joint venturers. No member firm has any authority (actual, apparent, implied or otherwise) to obligate or bind KPMG International or any other member firm, nor does KPMG International have any such authority to obligate or bind KPMG International or any other member firm, in any manner whatsoever.

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.

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.