THE
# BANK STATEMENT
Q3 2015 NEWSLETTER



KPMG
*cutting through complexity*

> "Client clearing is an evolving area and banks will need to continue to invest time to perform the relevant analyses."

**Elizabeth Graystone,**
Banking Accounting Advisory,
KPMG in the UK

## NEGATIVE INTEREST RATES AND CLIENT CLEARING

Welcome to the Q3 2015 issue of our quarterly banking newsletter in which we provide updates on IFRS developments that directly impact banks and consider the potential accounting implications of regulatory requirements.

**Highlights**

- **Spotlight on IFRS 9**: the European Financial Reporting Advisory Group surveys financial institutions on implementation of IFRS 9 *Financial Instruments* – see page 2.
- The IASB decides to go for a second discussion paper in its **macro hedging project** and continues discussing **financial instruments with characteristics of equity** – see page 5.
- **Accounting challenges and questions** arising from **negative interest rates**: we look at some of the common issues – see page 8.
- **Client clearing of OTC derivatives** continues to generate debate. We look at the impact on a clearing member's balance sheet – see page 12.

## EFRAG issues results of its pre-endorsement questionnaire

In August 2015, the European Financial Reporting Advisory Group (EFRAG) published the results of its follow-up questionnaire on IFRS 9 *Financial Instruments* (the EFRAG report). This questionnaire was a follow-up to the ones carried out in 2012 and 2013, and aimed to find out to what extent the concerns raised by constituents in previous field tests still apply after the publication of the final standard in July 2014.

The participants were as follows.

| Participants | | | |
|---|---|---|---|
| **By country** | | **By industry** | |
| France | 10 | Banking | 11 |
| Germany | 8 | Insurance | 4 |
| Italy | 1 | Other industries | 9 |
| Sweden | 1 | | |
| UK | 4 | | |
| | **24** | | **24** |

The questionnaire focused on:

- classification and measurement;
- the interaction between IFRS 9 and the insurance contracts standard;
- expected credit losses;
- costs related to implementing the impairment model; and
- general hedge accounting.

### *Classification and measurement*

The majority of participants have performed a preliminary qualitative impact analysis and aimed to carry out a quantitative analysis during 2015–17. However, one participant from the banking sector noted that its quantitative analysis would not be started until the standard is endorsed by the EU.

The majority of participants estimated that the following percentages of financial assets in the existing IAS 39 *Financial Instruments: Recognition and Measurement* categories would meet the solely payments of principal and interest (SPPI) criterion.

| Existing IAS 39 classification | Percentage meeting SPPI criterion |
|---|---|
| Loans and receivables | 95–100% |
| Held to maturity | Almost 100% |
| Available-for-sale debt instruments | 80–100% |

The EFRAG report provides more details on entities' progress in implementing the classification and measurement requirements and their views on the types of financial instruments that would meet or fail the SPPI criterion.

Participants were divided on the SPPI criterion's implications for their lending practices.

## *Interaction between IFRS 9 and the insurance contracts standard*

Participants from the insurance and banking industries had different views on how to resolve the interaction between IFRS 9 and the forthcoming new standard that will replace IFRS 4 *Insurance Contracts*.

All participants from the insurance industry argued that IFRS 9's effective date should be deferred for the insurance industry until the new insurance contracts standard becomes effective, or that its adoption should be voluntary until that time. The main concern regarded the usefulness of financial reporting for users of financial statements in the period between the application of IFRS 9 and the new insurance contracts standard, because stakeholders would experience two major changes in an insurer's financial statements in short succession.

## *Expected credit losses*

All participants from the banking and insurance industry had to some extent analysed the IFRS 9 impairment requirements. Most of those expected to have a materially complete understanding of the impairment requirements in 2015.

The respondents who answered this question (approximately half) indicated that their risk management systems were currently partly compliant with IFRS 9 but they expected to be fully in line with the standard in the future.

Participants from the banking and insurance sectors noted that they aimed to leverage their existing regulatory approach and stress testing methodologies in order to achieve consistency between the regulatory and the accounting models. They expected to make adjustments to their regulatory systems such as the following:

- including current and forward-looking information;
- adjusting existing regulatory risk parameters based on a through-the-cycle or downturn perspective; and
- measuring the default risk on an instrument, rather than using a counterparty basis.

Some participants were able to provide a quantitative impact assessment of the expected credit loss requirements, as follows:

- *loans:* an increase in loss allowances of between 25 and 50 percent for the majority of the respondents;
- *debt securities:* estimates ranged from no change to an increase of more than 100 percent; and
- *other financial instruments:* increase mainly in the range of 0–25 percent.

## *Costs related to implementing the impairment model*

Half of the participants from the banking and insurance industries answered this question, and they expected significant costs in implementing the impairment requirements. Some of these participants estimated implementation efforts at 25,000 to 40,000 man-days.

The following areas were highlighted in this context:

- building new specific IFRS 9 models;
- significant IT costs to meet new disclosure requirements;
- significant costs relating to the new requirements on modification of financial assets; and
- costs relating to reconciliation between IFRS 9 and Basel numbers.

### *General hedge accounting*

Some participants identified areas that were still unclear or that had not been solved by the final version of IFRS 9. Some of the specific issues raised included:

- the application of the EU carve-out;
- reliance on part of the implementation guidance from IAS 39 that was not transferred to IFRS 9; and
- the application of proxy hedging.

### *Overall assessment of the standard*

Some participants from the banking industry recommended that IFRS 9 be endorsed and some recommended early endorsement. No participants recommended not endorsing it.

## EFRAG issues endorsement advice on IFRS 9

On 15 September 2015, EFRAG submitted its endorsement advice on IFRS 9 for use in the EU and European Economic Area. The endorsement advice concludes that, overall, IFRS 9 meets all technical endorsement criteria of the *IAS Regulation*, except for the impact on the insurance industry of applying IFRS 9 before the finalisation of the forthcoming insurance contracts standard.

EFRAG noted that the IASB is working on a solution for the insurance industry and is expected to make decisions in the next two months. EFRAG will provide further advice relevant to the insurance industry as the IASB work proceeds.

EFRAG recommended that businesses carrying out insurance activities be permitted (rather than required) to account for financial instruments in compliance with IFRS 9.

## ITG tackles some difficult areas of judgement

At its second substantive meeting – in September 2015 – the IFRS Transition Resource Group for Impairment of Financial Instruments (ITG) discussed further issues that were submitted by stakeholders[1].

The main points raised at the meeting were as follows.

- ITG members appeared to agree that internal credit risk ratings and behavioural indicators may be valuable tools in applying the new standard.
- IASB board members explained their belief that estimates of expected credit losses on revolving credit facilities should not include losses on expected draw-downs that exceed contractual credit limits.
- Entities will need to consider how to incorporate relevant forward-looking information into their estimates. The nature of inputs and models used for this purpose are likely to evolve over time.
- Disclosures are important in explaining how estimates have been made – including whether any relevant factors have been excluded.
- A representative of the Basel Committee on Banking Supervision reported that its final guidance on accounting for expected credit losses would be published before the end of 2015, and explained the changes that it was making in response to comments received.

For each issue submitted, the IASB will consider what action – if any – is required.

The ITG's next meeting is planned for 11 December 2015. The deadline for submission of issues is 21 October 2015.

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

# IASB ACTIVITIES AFFECTING YOUR BANK

## Second discussion paper for macro hedging

In its July 2015 meeting, the IASB decided to issue a second discussion paper on its macro hedge accounting project before publishing an exposure draft. This is because the comment letters and feedback that it received did not include sufficient information to enable the Board to develop an exposure draft. However, the IASB will consider the possibility of moving straight to an exposure draft if further deliberations lead to a comprehensive solution addressing recognition, measurement and disclosure requirements.

Also in July 2015, the Board approved the scope and approach for identifying the information needs of constituents. In particular, it decided that the scope should include information needs arising both when:

- entities carry out dynamic risk management activities; and
- entities face interest rate risk but do not carry out dynamic risk management activities to manage the risk.

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

## Financial instruments with characteristics of equity

At its September meeting, the Board focused on the classification of non-derivatives. It:

- discussed the extent to which the requirements in IAS 32 *Financial Instruments: Presentation* capture the features that users need to make their assessments; and
- considered three possible classification approaches.

Classification of derivatives will be considered at a future meeting.

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

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

In July 2015, the Board discussed how to proceed with the measurement proposals included in the exposure draft (ED) *Measuring Quoted Investments in Subsidiaries, Joint Ventures and Associates at Fair Value.*

The IASB decided to undertake further research on:

- the fair value measurement of investments in subsidiaries, associates and joint ventures that are quoted in an active market; and
- the measurement of the recoverable amount of cash-generating units on the basis of fair value less costs of disposal when the cash-generating unit is an entity that is quoted in an active market.

The IASB will continue its discussion on this topic at future meetings.

## IFRS 15: New effective date

In September 2015, the IASB confirmed a one-year deferral of the effective date of its new revenue standard by issuing an amendment to the standard. Companies are now required to apply IFRS 15 *Revenue from Contracts with Customers* no later than 1 January 2018. Early adoption continues to be permitted.

Furthermore, because users and preparers of financial statements have said that they find some aspects of IFRS 15's revenue requirements unclear, in July 2015 the IASB published proposed amendments to the new standard: exposure draft ED/2015/6 *Clarifications to IFRS 15.*

The proposed amendments focus on changes and clarifications relating to:

- licences;
- principal vs agent;

- identifying performance obligations; and
- transition.

The FASB plans several detailed exposure drafts, but the IASB expects to issue just this one set of targeted amendments.

The deadline for submitting comments to the IASB is 28 October 2015. The IASB expects to complete its redeliberations on the amendments by the end of 2015.

## IFRS 9: Transition for hedge accounting

In September 2015, the IFRS Interpretations Committee discussed two hedge accounting issues relating to the transition from IAS 39 to IFRS 9:

1. whether an entity can treat a hedging relationship as a continuing hedging relationship on transition from IAS 39 to IFRS 9 if it changes the hedged item from an entire non-financial item to a component of the non-financial item (as permitted by IFRS 9) in order to align the hedge with the entity's risk management objective; and
2. whether an entity can continue with its original hedge designation of the entire non-financial item under IFRS 9.

The Committee noted that paragraph 7.2.22 of IFRS 9 requires a change to the hedged item to be reflected on a prospective basis. Also, changing the hedged item while continuing the original hedge relationship would be equivalent to the retrospective application of the hedge accounting requirements in IFRS 9, which is prohibited except in the limited circumstances described in paragraph 7.2.26 of IFRS 9. The Committee observed that for issue 1 those limited circumstances do not apply and therefore the original hedge relationship could not be treated as a continuing hedge relationship on transition to IFRS 9.

In relation to issue 2, the Committee observed that:

- IFRS 9 supports the use of hedge designations that are not exact copies of actual risk management ('proxy hedging') if they reflect risk management in that they relate to the same type of risk that is being managed and the same type of instruments that are being used for that purpose; and
- the use of proxy hedging in cases in which it reflects the entity's risk management did not appear to be restricted to instances in which IFRS 9 had prohibited an entity from designating hedged items in accordance with its actual risk management.

Accordingly, the Committee noted that hedge designations of an entire non-financial item could continue on transition to IFRS 9 if they meet the qualifying criteria in IFRS 9. The Committee tentatively decided not to add these issues to its agenda.

## IAS 32: Classification of the liability for a prepaid card in the issuer's financial statements

In September 2015, the IFRS Interpretations Committee discussed how an entity would classify the liability – i.e. as a financial or non-financial liability – when it issues a prepaid card and how the entity would account for the unspent balance of the card, considering that the entity does not have an obligation to deliver cash to the merchant(s). The prepaid card had the following features:

- no expiry date;
- cannot be refunded, redeemed or exchanged for cash;
- is redeemable only for goods or services;
- is redeemable only at selected merchants (which may include the entity), and, depending on the card programme, ranges from a single merchant to all merchants that accept a specific card network. On redemption by the cardholder at a merchant(s) to purchase goods or services, the entity has a contractual obligation to pay cash to the merchant(s);

- no back-end fees, which means that the balance on the prepaid card does not reduce unless it is spent by the cardholder; and
- is not issued as part of a customer loyalty programme.

The Committee observed that the liability of the entity for the prepaid card meets the definition of a financial liability, because the entity has a contractual obligation to deliver cash to the merchants on behalf of the cardholder and the entity does not have an unconditional right to avoid delivering cash to settle this contractual obligation.

In light of the existing guidance in IAS 32 and IFRS 9 (IAS 39), the Committee tentatively decided not to add this issue to its agenda.

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## IAS 39: Separation of an embedded interest rate floor from a floating rate host contract in a negative interest rate environment

In September 2015, the IFRS Interpretations Committee discussed the application of the embedded derivative requirements of IAS 39 in a negative interest rate environment. Specifically, the Committee considered:

- whether paragraph AG33(b) of IAS 39 should apply to an embedded interest rate floor in a floating rate host debt contract in a negative interest rate environment; and
- how to determine the 'market rate of interest' referred to in that paragraph.

The Committee observed that:

- paragraph AG33(b) of IAS 39 should be applied in a negative interest rate environment in the same way as it would be applied in a positive interest rate environment; and
- to determine the market rate of interest for the purpose of applying paragraph AG33(b) of IAS 39, an entity is required to consider the specific terms of the contract, including the relevant credit or other spreads appropriate for the counterparty and the market in which it is operating.

The Committee tentatively decided not to add this issue to its agenda.

## Insurance contracts project

In July, the Board continued its discussions on the accounting consequences of temporary volatility and accounting mismatches in profit or loss caused by the different effective dates of IFRS 9 and the forthcoming insurance contracts standard.

At its September meeting, the Board discussed:

- addressing the consequences of differing effective dates of IFRS 9 and the new insurance contracts standard;
- disaggregating changes in market variables for contracts; and
- mitigating risks related to direct participating insurance contracts.

For more information, see our *IFRS Newsletter: Insurance*, July and September 2015 (forthcoming).

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# NEGATIVE INTEREST RATES – NEW ACCOUNTING CHALLENGES AND QUESTIONS

> "Negative interest rates lead to accounting challenges and questions that have not previously been considered."
>
> **Ewa Bialkowska,**
> KPMG in the UK

Until recently, negative rates were an unusual phenomenon. But in the past year, certain benchmark interest rates in various currencies and tenors have become negative and remained so. Negative interest rates create real economic challenges for banks and their customers, and the wider market economy. But they also lead to accounting challenges and questions that have not previously been considered. This article considers some of the common themes.

## *Is negative interest on a financial asset part of a bank's net interest margin?*

The presentation of negative interest arising on financial assets was discussed in the previous edition of *The Bank Statement* (Q2 2015) and was hotly debated in the run-up to the IFRS Interpretations Committee agenda decision published in January 2015.

The Committee noted that "interest resulting from a negative effective interest rate on a financial asset does not meet the definition of interest revenue in IAS 18 *Revenue*, because it reflects a gross outflow instead of a gross inflow, of economic benefits." This left a question of where to present such negative interest in a bank's statement of profit or loss and other comprehensive income – i.e. whether it can be included in interest expense, and within the net interest margin that banks generally present on the face of the income statement.

The appropriate presentation will require the application of judgement, taking into account the materiality of the amounts. In many cases, negative interest will be immaterial.

If the negative interest arising on financial assets is material, then its inclusion in 'interest income' would be inconsistent with the Committee's agenda decision. However, it may be appropriate to include it in 'interest expense' and cross-refer to a note that explains the amount and its nature.

If greater prominence is appropriate, then separate disclosure on the face of the income statement may be appropriate. One of the banks included in the 'How do you compare?' article in our Q2 2015 *Bank Statement* chose this presentation.

## *Impact of negative interest rates on derecognition analysis for financial assets*

An analysis of whether a financial asset should be derecognised often involves determining whether the financial asset has been transferred, as defined in IAS 39. If, as part of the transaction, a bank retains the contractual rights to receive the cash flows of the financial asset but assumes a contractual obligation to pass on the cash flows, then the arrangement qualifies as a transfer only if it meets the 'pass-through' criteria.

The concept of pass-through naturally envisages a scenario in which the transferor of the financial asset subject to the pass-through arrangement collects cash flows from the issuer of the asset, which the transferor is then obliged to pass on to the transferee. But how is this concept applied to a financial asset that requires the holder of the asset to make payments to the issuer, rather than to collect cash flows from the issuer?

IAS 39 doesn't envisage the scenario of negative interest rates and does not contain explicit guidance on whether pass-through should still be possible on such an asset, and if so how it should be incorporated into a derecognition analysis.

Accordingly, for an asset bearing a negative coupon, it will be necessary to understand the specific legal arrangements and apply judgement to apply IAS 39.

## *Impact of an interest floor of zero*

Complexities may arise if the contractual terms of a floating interest rate financial asset incorporate a floor of zero – i.e. in the event of the interest rate becoming negative, the coupon on the asset equals zero. In some countries that are currently experiencing a negative interest rate environment, it is not uncommon for an interest rate floor of zero to be incorporated in retail loans such as mortgages.

Sometimes there is a lack of clarity about contractual terms, and some banks are involved in legal disputes about whether the floors exist and whether instead their borrowers are entitled to receive payments from their banks.

Accounting complexities for an interest floor of zero may arise in relation to:

- hedge accounting; and
- potential separation of an embedded derivative in the form of a zero-rate floor.

## *Hedge accounting*

A debt instrument on which the interest rate is linked to a benchmark rate that is floored at zero and was originated before the benchmark became negative may be a hedged item in a cash flow hedge of the variability of interest cash flows.

The following is an example of such a hedging relationship:

- *hedged item:* variability in LIBOR cash flows receivable from a loan. LIBOR cash flows on the loan are floored at zero; and
- *hedging instrument:* interest rate swap that pays LIBOR and receives a fixed rate. LIBOR cash flows under the swap do not have a floor. The loan is not prepayable and credit risk is not significant.

In this example, if LIBOR becomes negative:

- LIBOR cash flows from the loan are zero and the overall interest receivable on the loan becomes fixed at the amount of the margin over LIBOR (if any); and
- under the interest rate swap, fixed coupons are received from the receive leg and variable cash flows are received from the pay leg – i.e. the swap receives negative LIBOR.

Accordingly, the LIBOR-based cash flows on the loan are fixed at zero (i.e. they are not variable) during the period when LIBOR is negative. However, there is still an exposure to variability in future interest cash flows due to changes in LIBOR, because LIBOR may turn positive in future periods – therefore, we believe that the designated hedged risk continues to exist and is eligible for hedge accounting in accordance with IAS 39.

Similarly, a question arises over whether the hedged LIBOR-based cash flows can still be regarded as highly probable, even though it is possible that the LIBOR component will be zero. Again, we believe that the analysis is not changed merely by LIBOR becoming negative – the hedged forecast transactions are the receipts of interest from the loan and these transactions are still forecast to occur; it is just that the LIBOR component may be zero.

However, when the floor alters the cash flow profile on the hedged item it can lead to immediate retrospective ineffectiveness, and ultimately result in a hedge failure. Entities testing effectiveness of the hedge using a hypothetical derivative technique would incorporate the floor feature into the hypothetical derivative, whereas the real derivative hedging instrument would in most cases be an interest rate swap without a similar floor.

If the hedge relationship is determined to be highly effective on a retrospective basis, then there is potentially a larger issue of whether it is expected to remain highly effective prospectively.

### *Potential separation of an embedded derivative*

IAS 39 requires an embedded derivative that meets certain conditions to be separated from a hybrid contract and accounted for separately as a derivative. The standard contains specific requirements in paragraph AG33(b) in relation to caps and floors. It states that an embedded floor on the interest rate on a debt contract is closely related to the host contract (which means that separation is not required) provided that the floor is at or below the market rate of interest when the contract is issued and the floor is not leveraged.

The issue of separation of an embedded derivative floor from a floating rate debt instrument with a benchmark floor of zero, whose benchmark interest rate is below zero at the time of issue of the instrument, has been subject to discussion. Two views emerged: one arguing that separation is required and one that it is not.

The issue was debated by the Committee in September 2015, which tentatively decided not to add this issue to its agenda.

In drawing this conclusion, the Committee observed that paragraph AG33(b) of IAS 39 makes no distinction between positive and negative interest rates and, therefore, its requirements should be applied consistently in both cases. The Committee also discussed how to interpret the term 'market rate of interest' for the purpose of applying paragraph AG33(b) of IAS 39 – see the 'IASB activities affecting your bank' section of this newsletter.

### *Is cash on term deposit with negative interest rate a cash equivalent?*

Cash equivalents are held for the purpose of meeting short-term cash commitments, rather than for investment or other purposes. The definition of cash equivalents in IAS 7 *Statement of Cash Flows* refers to "short term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to insignificant risk of changes in value".

Some have queried whether cash placed on term deposit with a negative interest rate, which means that the amount repayable will be less than the amount originally deposited, still qualifies as a cash equivalent for the purposes of IAS 7. However, a negative rate alone on a term deposit account will not generally alter the eligibility of the balance for classification as cash and cash equivalents.

### *Is a repo receivable a cash equivalent?*

The presence of negative rates on vanilla deposit accounts has also prompted some to look for alternative products that offer a positive return on the cash held to meet short-term commitments, such as reverse securities repurchase transactions (repos). For example, a bank may consider the following transaction.

**Example – Using repo transactions as short-term deposits**

Bank B desires a positive interest return for cash that it holds to meet its short-term cash commitments. It determines that the short-term repo market will provide this return. Accordingly, B uses the cash that it holds to execute a reverse repo transaction with Counterparty X under terms generally used in the repo market.

At inception of the reverse repo transaction, B transfers cash to X and obtains from X the legal title to collateral in the form of a highly rated government security. Simultaneously, X commits to repurchase the same security back from B in one month's time for an amount of cash equal to that transferred by B at inception plus a lender's return on the cash originally transferred.

At inception of the reverse repo, B recognises a financial asset: a reverse repo receivable. X does not derecognise the security collateral sold from its financial statements because it retains all of the related risks and rewards. Accordingly, B does not recognise the security collateral on its balance sheet. B then considers whether the reverse repo receivable meets the definition of cash equivalents in IAS 7.

This use of the repo market to place cash held for meeting short-term cash commitments has led to recent discussions on when and if a reverse repo receivable could be considered a cash equivalent.

Again, it is unlikely that the form of a deposit – i.e. collateralised lending in the form of a reverse repo rather than a plain deposit – would on its own affect the eligibility of the amount for classification as cash and cash equivalents in a bank's balance sheet. The analysis here would be similar to that for other cash deposits placed and would include consideration both of the 'purpose' test and of the definition in IAS 7. For example, if the reverse repo transaction is carried out as part of a bank's trading activities, then it would not be held for the purpose of meeting its short-term cash commitments.

# CLIENT CLEARING FOR OTC DERIVATIVES AND THE BALANCE SHEET CONUNDRUM

> "Client clearing continues to generate debate. This has been fuelled by a steady flow of changes and analysis."
>
> **Elizabeth Graystone,**
> Banking Accounting Advisory,
> KPMG in the UK

We have discussed client clearing arrangements and their impact on the size of clearing member (CM) banks' balance sheets in previous issues of *The Bank Statement*[2] but the topic continues to generate debate. This has been fuelled by a steady flow of changes: regulatory, central clearing party (CCP) rule book and accounting-based, as well as by more detailed analysis of specific arrangements. Attention is particularly focused on these arrangements because the size of a bank's capital requirements and other requirements – e.g. amounts due under bank levies – can be directly affected by whether assets and liabilities are recognised on a bank's balance sheet or are offset for accounting purposes.

CM banks are required to provide this globally important clearing service as a result of regulation and so have to take on the role of a CM for vast numbers of over-the-counter (OTC) transactions. The regulations driving this were introduced to reduce global financial systemic risk and mitigate the types of issues seen during the collapse of Lehman Brothers and MFG at the height of the financial crisis. Some question whether the role performed by CM banks, on behalf of the wider financial market, in guaranteeing the performance of their clients to CCPs when clearing OTC derivatives should have such a significant impact on the size of CM balance sheets. Indeed, should the transactions be on CM balance sheets at all?

CM banks are experiencing these impacts at a time when there has never been more pressure on these globally important financial institutions to hold ever increasing amounts of capital and so any activities that may increase such capital requirements are subject to increased scrutiny.

In this article we further explore the impact of client clearing on a balance sheet of a CM bank reporting under IFRS.

## *So what are the changes?*

| | |
|---|---|
| **Regulatory** | • Introduction of mandatory clearing for certain OTC derivatives in Europe by the *European Market Infrastructure Regulation* (EMIR) and in the US by the *Dodd-Frank Act*. These require certain OTC derivative transactions to be cleared through authorised exchanges via CMs. CM banks have obligations to clear both their proprietary trades and trades in which they act as a clearing counterparty for clients.<br>• Introduction of new regulatory ratios such as the leverage ratio[3] (which limits the size of a bank's balance sheet in line with the regulatory capital that it holds) and the net stable funding ratio[4] (which requires banks to maintain a certain ratio of liquid assets to its exposures). |
| **Accounting** | • Amendment to offsetting requirements of IAS 32 that came into effect on 1 January 2014. |

## *How acting as CM can expand a bank's balance sheet*

For IFRS accounting purposes, a CM has generally considered itself a party to two separate transactions: one with its client[5], and one with the CCP through which the client's transaction is cleared.

2. Q3 2013.
3. See *The Bank Statement*, Q1 2015.
4. See *The Bank Statement*, Q2 2015.
5. See *The Bank Statement*, Q3 2013.

## *Agent or principal?*

The client clearing regulations and clearing agreements may refer to the CM as the principal in certain arrangements and the agent in others when a CM bank clears OTC trades at a CCP on behalf of their clients. However, legal form alone does not dictate how the arrangement is ultimately accounted for under IFRS. Therefore, when a CM bank enters into a client clearing arrangement an analysis is required of whether, for accounting purposes, the substance of the contractual arrangements is that the entity is merely acting as an agent in processing a trade between its client and the CCP or is becoming a principal party to back-to-back trades with the client and the CCP. This analysis involves judgement and consideration of all relevant facts and circumstances.

Under IAS 39, a bank recognises a financial instrument on its balance sheet when it becomes party to the contractual provisions of the instrument. The analysis of whether a CM has become party to one or more financial instruments as a result of the client clearing transactions may be complex and can be further complicated by the pace of change in the market around the global clearing processes.

As part of the client clearing arrangements, the CM generally bears the credit risk of its clients and takes on an obligation to the CCP in respect of the settlement of amounts due under the cleared OTC trade and provision of collateral. This has in turn generally been considered to point to the CM acting as the principal in respect of applying IFRS to accounting for its client clearing business – i.e. the financial instruments arising out of this contractual arrangement are analysed as two – equal and opposite – derivative contracts, one facing the CCP and one facing the client, coupled with associated collateral balances where appropriate.

## *Grossing up*

If the contracts do not meet the IFRS requirements for offsetting, then this would lead to the grossing up of the CM's balance sheet as follows.

### Gross-up 1: Two derivatives to book for each client cleared trade

The CM records a derivative transaction with its client and a 'mirror' with the CCP. This would add a derivative asset and a derivative liability to the CM's balance sheet.

### Gross-up 2: Initial cash margin received from a client

For each trade cleared, there is a requirement to post a one-off cash initial margin (IM) with the CCP. Posting of an IM by the client may lead to the simultaneous recognition by the CM on its balance sheet of a cash asset and a related collateral obligation liability to the client.

### Gross-up 3: Variation margin received from a client

During the life of the transaction, the client will be required to post a cash variation margin (VM) with the CM, which, assuming that the payment of the VM is not considered settlement (see below), will add an asset and a liability to the CM's balance sheet in the same way as for the IM above.

This is illustrated in the example below.

**Example 1 – Grossing up - illustration**

**Fact pattern**

Client C enters into an OTC interest rate swap with an execution broker and then submits the trade to its nominated CM bank for clearing at the CCP. The fair value of the interest rate swap and the cash margin requirements of the client leg of the transaction are as follows (assuming that gross presentation is appropriate).

| | | |
|---|---|---|
| Fair value of interest rate swap: | at inception: | 0 |
| | at year end: | 150 |
| IM | on novation for clearing: | 10 |
| VM | at year end: | 150 |

At year end, the above balances are reflected on the CM's balance sheet as follows.

| | Asset | Liability |
|---|---|---|
| Derivative asset (client (C)-facing trade) | 150 | |
| Cash – IM received (received from C) | 10 | |
| Cash – VM received (received from C) | 150 | |
| Derivative liability (CCP-facing trade) | | 150 |
| Collateral received (obligation to C for the IM) | | 10 |
| Collateral received (obligation to C for the VM) | | 150 |

The CM faces identical margin requirements from the CCP, which would lead to a re-allocation of the CM's own cash on the CM's balance sheet, but would generally have no overall impact on the size of the CM's balance sheet – e.g. the CM could use the 160 of cash received from C to fund the deposit of 160 cash margin with the CCP.

## *Gross or net?*

The CM will need to determine whether making the VM payments and receipts:

- represents a partial settlement of contractual rights to receive or obligations to pay cash under the relevant derivative contracts, which would require derecognition of the variation margin payments or receipts and the corresponding carrying amount of the relevant derivative contracts at the time of payment; or
- relate to a VM balance that is a separate financial asset or financial liability. For example, this may be the case if the balance may be required to be repaid in the future or may be used to settle the derivative contract at its maturity.

## *Are payments of VM a settlement?*

Whether the payment or receipt of a variation margin represents a settlement of a derivative contract should be assessed with reference to the concepts of extinguishment – i.e. the obligation specified in the contract is discharged or cancelled or expires – and of expiry of contractual rights to cash flows. Whether these derecognition criteria are met will depend on the specific contractual terms considered in conjunction with other relevant documentation and applicable law.

### Example 2 – Payment of VM represents settlement

On 25 May 2015, Company B enters into a futures contract through Clearing House C to buy a specified quantity of shares in Company X for 100 in three months. The contract states that:

- B will pay (receive) a VM in cash to (from) C equal to the decrease (increase) in the market futures price at the end of each day; and
- the exercise price payable on maturity of the contract will be reduced (increased) by an amount equal to the amount of VM paid by B to C (received by B from C).

The contract does not allow for the VM to be repaid and no interest is payable on the VM.

On 26 May 2015, the market futures price declines to 98. At the end of that day, B pays a VM of 2 to C and the exercise price is reset to 98.

B concludes that the payment of the VM represents a settlement of the futures contract because it extinguishes a specified part of its obligation to pay the exercise price on maturity.

Immediately before payment of the VM on 26 May 2015, the futures contract is a derivative liability of 2. The payment of the VM represents a derecognition of the derivative liability and, following the payment of 2, the fair value of the futures contract is zero because it has an exercise price equal to the current market price.

### Example 3 – Payment of VM represents separate asset

Company X enters into a 10-year interest rate swap derivative with Clearing House C. The derivative requires net payments of coupons on each anniversary of the transaction through to maturity. The rules of C state that:

- X will pay (receive) a VM in cash to (from) C at the end of each day, such that the net accumulated balance of the VM is equal and opposite to the estimated fair value of all outstanding swap contracts between X and C;
- interest at a market rate is payable on the accumulated balance of VM;
- a party is entitled to set off the net balance of VM that it has paid (or received, as the case may be) against the obligation to make any payment (or right to receive any payment) of coupons on the swap contract on the date on which those coupons fall due for settlement; and
- on maturity or termination of all swap transactions between X and C and following settlement of all payments due under those swap contracts, any remaining balance of the VM is returned to the party that paid it.

X concludes that the payment of the VM does not represent a settlement of rights or obligations under the derivative. This is because these amounts will continue to become due and payable in the future in accordance with the terms of the derivative and are not reduced or increased by any amount of VM received or paid.

The accumulated VM balance represents a separate financial asset or financial liability because:

- the accumulated balance will either be used in the future to settle payments on this or other swaps or be returned to the payer; and
- interest is payable on the accumulated balance.

In February 2015, the Chicago Mercantile Exchange (CME) filed a notice with the SEC clarifying that the payment of a VM within its daily settlement process results in the derivative exposures being settled on a daily basis[6].

This clarification has a potentially significant accounting consequence for trades cleared at the CME because, as illustrated above, when a VM payment is considered to be settlement, the payment/receipt of the VM from a client or the CCP leads to derecognition of the equivalent amount of the corresponding derivative transactions rather than grossing up of the CM's balance sheet (assuming that the VM balances are otherwise recognised assets/liabilities and are not offset). The clarification issued by the CME could potentially lead to similar accounting for OTC positions cleared there, as is currently appropriate for many futures contracts. For transactions cleared at the CME, this may mean that instead of going through an analysis to determine whether accumulated VM balances recognised as assets or liabilities should be offset, the net position for each derivative transaction would in effect be reflected automatically as the relevant balances are settled.

## *Is VM offset against the related derivative balance?*

If payments and receipts of VM are not a settlement of the related derivatives, then the CM needs to consider whether the VM balance and the related derivatives should be offset in the balance sheet. For example, CMs are familiar with the requirement to offset VM balances against the associated interest rate swap derivative positions when they are cleared via LCH Swapclear and certain other CCPs.

### Example 4 – Offsetting

Bank K is a member of Clearing House H. Transactions entered into with other members of H are novated such that H is the legal counterparty to K for all such transactions. The contractual terms are as follows:

- cash margins are payable or receivable between K and H based on the fair value of outstanding transactions;
- the payment (receipt) of a cash margin does not itself extinguish or settle any obligation (right) to make (receive) future cash flows under the outstanding transactions; rather, it creates a distinct receivable (payable) that may be set off against those obligations (rights) when they mature;
- only one net cash payment or receipt, which covers final settlement of maturing transactions, periodic payments on existing transactions and net payment or receipt of cash margin, occurs each day between K and H; and
- in the event of default, insolvency or bankruptcy of any of the parties in the arrangement, the outstanding amounts will be set off.

In our view, the cash flows arising from each daily settlement are, in effect, net settlements. Accordingly, offsetting is appropriate in these circumstances. This is because, despite uncertainties about the amounts and timing, payments that will arise in the future will be set off. The passage of time or uncertainties in amounts to be paid will not preclude K from currently having a legally enforceable right to set off. Therefore, because K has the current legally enforceable right to set off and the intention to settle net or simultaneously, it satisfies the offsetting criteria in IAS 32.

6. See SEC filing CME, 3 February 2015.

For client cleared trades, an analysis is required of whether the client-facing derivatives and their VM balances meet the requirements for offsetting and, similarly, an analysis is required of the CCP-facing derivatives and their VM balances.

## Is cash collateral an asset?

In addition to the debate about whether the CM is acting as a principal or an agent in the clearing transaction, some raise the question whether the IM cash collateral received and posted on behalf of their clients at the CCP is an asset of the CM bank.

We discussed the issue of client money more generally in our Q2 2015 issue of *The Bank Statement*, and the features highlighted in that article are also relevant for any analysis of whether IM balances posted by clients to the CM represent assets of the CM, and whether associated liabilities to repay collateral are also booked.

Such an analysis would require a detailed review of the legal arrangements, including:

- protections in place for the client as part of the clearing service, and the impact of default by the client, CM or CCP; and
- a clear understanding of the specific operational aspects of how the CM receives, segregates and subsequently posts the cash margin with the CCP.

If it is concluded that the cash collateral posted by the client is not an asset of the CM, then neither the cash asset nor the obligation to return the cash to the client is recognised in the CM balance sheet. For example, UBS's Q4 2014[7] results disclosed that the bank removed the IM cash balances associated with certain client cleared trades from their IFRS balance sheet.

## The devil is in the detail

The accounting analyses highlighted above can be extremely time-consuming and involve multiple inputs from the business, operations, legal departments and sometimes external counsel. The analysis is generally required at the product level and so each CCP's individual clearing service for each product requires a separate exercise.

The amendments to the IAS 32 offsetting requirements that became effective in 2014 resulted in a significant amount of analysis of CMs' proprietary positions at CCPs, which involved the added complexity of considering the interaction between various CCPs' rule books and national and supranational laws and regulations. To the extent that client clearing transactions were not included in the review of such proprietary balances, the additional analysis could also require significant investment of time.

## Next steps

It is likely that other CCPs will follow the CME's example and seek to make changes to their rules so that any VM that a CM pays or receives represents settlement rather than receipt of collateral. In addition, similarly to UBS, CMs – and CCPs – may well consider making changes to the way they transact clearing business with their clients, so that it is appropriate not to recognise cash collateral balances on their balance sheets.

The client clearing is an evolving area and CM banks will need to continue to invest time to perform the relevant analyses and keep abreast of changing market practice to ensure their IFRS accounting treatment remains appropriate.

7. See the discussion in *The Bank Statement* Q2 2015.

## ESMA publishes extracts of its database of enforcement decisions

On 21 July 2015, the European Securities and Markets Authority (ESMA) issued the 17th extract from its confidential database of enforcement decisions on financial statements[8]. The aim of the publication is to strengthen supervisory convergence and provide issuers and users of financial statements with relevant information on the appropriate application of IFRS.

The decisions included in this extract were taken by national enforcers in the period from February 2013 to November 2014. ESMA expects to publish the next extract later in 2015.

The document describes seven enforcement decisions, three of which are particularly relevant for banks:

- extinguishment of debt;
- impairment charge for a decline in the fair value of available-for-sale assets; and
- measurement of financial instruments at fair value.

### *Extinguishment of debt*

#### Fact pattern

An issuer of a bond renegotiated its term with the bondholders following a forecast cash shortage. As a result, instead of repaying the bond the issuer agreed to give the bondholders a 33 percent equity stake in its fully owned subsidiary.

On settlement date, the issuer recorded the following entries in its consolidated financial statements:

- derecognised the bonds (carrying amount 8,000) and recognised a loss of 500 corresponding to the difference between the fair value of the equity stake (8,500) and the carrying amount of the bonds (8,000);
- increased the non-controlling interests (NCI) by 5,000 (being the book value of the 33 percent stake); and
- attributed the residual difference of 3,500 (fair value of 33 percent stake minus accounting value of 5,000) to equity.

#### Enforcer's decision

The enforcer agreed with the accounting policy applied by the issuer and noted the following.

- Paragraphs 30 and 31 of the previous consolidation standard IAS 27 *Consolidated and Separate Financial Statements* (now paragraphs 23 and B96 of IFRS 10 *Consolidated Financial Statements*) require any difference between the amount by which the NCI are adjusted and the fair value of the consideration paid/received to be recognised in equity.
- The application of IAS 27 (now IFRS 10) would not have reflected the fact that the fair value of the consideration paid to redeem the liability (33 percent stake in the subsidiary – i.e. 8,500) was higher than the accounting value of the liability (8,000).
- The application of IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments* results in a loss, which reflects the economic substance of the transaction – i.e. the issuer paid a premium to extinguish its debt.
- In 2012, the IFRS Interpretations Committee discussed a potential conflict between paragraphs 30 and 31 of IAS 27 and the provisions of IFRIC 17 *Distributions of Non-cash Assets to Owners* on the issue of a non-cash acquisition of NCI and concluded that the difference between the fair value of the assets transferred and their carrying amount from the derecognition of those assets should be accounted for in profit and loss. Therefore, it can be argued that the same reasoning applies to the derecognition of a liability.

8. Available on ESMA's website.

## *Impairment charge for a decline in the fair value of available-for-sale assets*

### Fact pattern

An entity classified its investment in the shares of unlisted companies as available-for-sale under IAS 39.

For the purpose of carrying out an impairment analysis, it defined a 'significant decline' as a decrease in the fair value of the investments that was more than the relative decrease in the value of a basket of relevant stock market indices. Therefore, the entity did not recognise impairment even when the absolute reduction in the fair value of some investments was 60–70 percent of the original cost.

In addition, the entity believed that a 'prolonged decline' was a decline in the fair value over a period of three to five years.

However, even when these significant or prolonged thresholds were met, the issuer considered the circumstances further and did not necessarily recognise impairment.

### Enforcer's decision

The enforcer disagreed with the entity and concluded that the entity had made an unreasonable judgement in its definition of 'significant or prolonged'. The enforcer noted that, because no quantitative threshold for 'significant or prolonged' is defined in IAS 39, entities should determine appropriate thresholds by considering, for example, other available guidance and market practices.

The entity's judgement was outside the range of thresholds that the enforcer had seen previously and understood to be commonly applied. In particular, the enforcer considered it to be unreasonable for the issuer to have a policy that allowed a reduction in fair value as large as 60–70 percent of the original cost to be considered not significant.

The enforcer noted that ESMA's *Review of Accounting Practices – Comparability of IFRS Financial Statements of Financial Institutions in Europe* found that financial institutions considered a decline of:

- 20 to 50 percent of the original cost to be significant; and
- six months to three years to be prolonged.

## *Measurement of financial instruments at fair value*

### Fact pattern

An entity classified its investment in shares as available-for-sale. The shares were measured on the basis of stock exchange prices when the shares were listed on an active market or based on valuation techniques when there was no active market.

An 'active market' was assessed by the issuer based on the following benchmarks:

- daily percentage of average value of trades/capitalisation lower than 0.05 percent;
- daily equivalent value of trades lower than 50,000;
- daily bid-ask spread greater than or equal to 3 percent;
- maximum number of consecutive days with unvaried prices greater than three; and
- percentage of trading days lower than 100 percent.

Based on the above, the entity considered some of the investments in listed companies as not traded in active markets and measured them based on a valuation technique using Level 3 inputs.

### Enforcer's decision

The enforcer disagreed with the issuer's accounting treatment and considered that quoted prices should have been used to measure fair value in accordance with IFRS 13 *Fair Value Measurement*. It noted that:

- IFRS 13 defines 'active market' as a market in which transactions take place with sufficient frequency and volume to provide ongoing pricing information;
- paragraph B37 of IFRS 13 provides indicators to identify a significant decrease in the volume or level of activity of traded instruments. The indicators used by the issuer were insufficient to conclude that the transaction price did not represent fair value, or that transactions occurred with insufficient frequency or volume;
- the issuer did not gather sufficient information to determine whether transactions were orderly or provided pricing information – it was not possible to conclude that the markets were not active;
- paragraph 72 of IFRS 13 states that "the fair value hierarchy gives the highest priority to quoted prices (unadjusted) in active markets… and the lowest priority to unobservable inputs";
- paragraph 77 of IFRS 13 states that "a quoted price in an active market provides the most reliable evidence of fair value and should be used without adjustment"; and
- the valuations used to measure the fair value of the instruments were far above the quoted prices, which raised additional concerns for the enforcer.

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