

The Bank Statement

IFRS – Global Banking Newsletter

“ITG discussions raised expectations about model sophistication a number of notches.”

– **Jonathan Bingham,**
Financial Services,
KPMG in the UK

Measuring ECL and clearing OTC derivatives

Welcome to the Q1 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 EU's endorsement of IFRS 9 *Financial Instruments* is now expected in H2 2016 – see [page 2](#).

The headaches of impairment

By now, most banks are engaged in the heavy lifting phase of their implementation projects: replacing their 'old-style' impairment models with new ones able to measure expected credit losses.

Estimating expected credit losses requires a view on possible future economic conditions and how these conditions will impact credit quality.

We look at some of the emerging practices in this complex area – see [page 8](#).

How do you compare? Disclosure about the impacts of IFRS 9

We have looked at the 31 December 2015 accounts of eight major European banks reporting under IFRS to see what information they have disclosed about IFRS 9 – see [page 14](#).

Regulation in action: More change on client clearing for OTC derivatives

When a clearing member of LCH.Clearnet elects to convert a collateral-to-market contract into a settled-to-market contract, it may need to consider accounting implications. This article discusses some of these implications – see [page 17](#).

Spotlight on IFRS 9

The EBA aims to understand the impact of IFRS 9 on regulatory capital.

EFrag postpones endorsement of IFRS 9

The European Financial Reporting Advisory Group (EFRAG) has indicated that the EU endorsement of IFRS 9 *Financial Instruments* is now expected in H2 2016. However, EFRAG clarified that the deferral is a result of deadlines within the European endorsement process and is not primarily technically motivated.

EBA launches an IFRS 9 impact assessment on EU banks

In January 2016, the European Banking Authority (EBA) announced that it is launching an IFRS 9 impact assessment on a sample of approximately 50 financial institutions across the EU. The EBA has explained that its aim is to:

- understand the estimated impact of the standard on regulatory capital;
- assess the interaction between IFRS 9 and prudential requirements; and
- assess how institutions are preparing to adopt IFRS 9.

The EBA acknowledges that institutions are currently in the process of developing systems and processes to implement IFRS 9 and so the quality of information will improve in the future. It intends to repeat the assessment closer to the implementation date of IFRS 9.

We understand that the selected sample of entities aims to represent the banking sector in the EU and consists of institutions of different sizes, business models and risk profiles. National competent authorities have discretion to extend this exercise to other banks in their jurisdictions. The EBA may enlarge its sample when it carries out similar exercises in the future.

Approximately 50 financial institutions are invited to provide:

- qualitative information about the most significant estimated impacts for an institution, highly judgemental aspects and the possible impact on lending practices and behaviour; and
- certain quantitative information.

We understand that it is intended for the assessment to be finalised during H2 2016. It is not clear whether the results will be made publicly available.

Impact of IFRS 9 on insurers

In March 2016, the IASB discussed feedback on its exposure draft *Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts* (the ED). The ED aimed to address concerns about the differing effective dates of IFRS 9 and the forthcoming insurance contracts standard.

The Board confirmed that the proposals in the ED for a temporary exemption from applying IFRS 9 for qualifying entities and the overlay approach would be retained as options. It also confirmed that eligibility for the temporary exemption would be assessed at the reporting entity level and that it would have a fixed expiry date.

Its discussions will continue in April and May, and the final amendments to IFRS 4 are currently expected to be published in September.

For more information, see our *IFRS Newsletter: Insurance*, [March 2016](#).

IASB activities affecting your bank

The IASB will feed the research from its measurement ED into the post-implementation review of IFRS 13.

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

In January 2016, the IASB discussed the findings of its research on the measurement proposals included in the exposure draft *Measuring Quoted Investments in Subsidiaries, Joint Ventures and Associates at Fair Value* issued in September 2014.

The discussion focused on the feedback received from users and preparers, including the Global Preparers Forum, and the outcome of the academic literature review undertaken.

The Board agreed to feed the work carried out during the research into the post-implementation review (PIR) of IFRS 13 *Fair Value Measurement*. Further work will be considered by the Board if the PIR identifies this as a critical area in which entities have encountered significant problems in implementing the standard.

Financial instruments with characteristics of equity

In February 2016, the IASB continued its discussions on financial instruments with characteristics of equity, having previously addressed the challenges of accounting for the classification of derivatives on 'own equity'. The discussions were part of a project to explore the potential ways of improving IAS 32 *Financial Instruments: Presentation*.

As financial markets have become more sophisticated, the number and complexity of financial instruments has increased. A single distinction between liabilities and equity cannot convey all of the similarities and differences between claims. For this reason, the Board decided that the objective of the project should include exploring potential improvements to presentation and disclosure in addition to improvements to the distinction between liabilities and equity alone.

The Board discussed:

- using sub-classes of financial liabilities to provide additional information that is useful to assessing financial performance and financial position;
- using sub-classes within equity to provide additional information about relevant features; and
- claims with conditional alternative settlement outcomes.

The next step for the project will be to develop the proposed approaches further so that the Board can ultimately form a preliminary view on its preferred approach. This is in line with the objective of this research project – which is “to investigate perceived financial reporting challenges with IAS 32 *Financial Instruments: Presentation* and to assess potential ways to improve financial reporting or to remedy an identified deficiency”.

For more information, see our *IFRS Newsletter: Financial Instruments*, [February 2016](#).

Classification of liability for a prepaid card in the issuer's financial statements

This topic was previously discussed by the IFRS Interpretations Committee in September 2015. It related to a question on how an entity would classify the liability for a prepaid card issued and how it would account for the unspent balance of such a card. The example prepaid card discussed had the following features:

- no expiry date;
- cannot be refunded, redeemed or exchanged for cash;
- is redeemable only at selected merchants;
- 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);
- has 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 under a customer loyalty programme.

The Committee was asked to consider whether the entity's liability in respect of the card is a non-financial liability, because the entity does not have an obligation to deliver cash to the cardholder.

In its September 2015 meeting, the Committee observed that, because the entity does not have an unconditional right to avoid delivering cash when the cardholder redeems the prepaid card at a third party merchant, the liability of the entity meets the definition of a financial liability. Consequently, an entity that issues such a card should apply the requirements in IFRS 9 (IAS 39 *Financial Instruments: Recognition and Measurement*) to determine whether and when to derecognise the liability for a prepaid card. At that meeting, the Committee also concluded that neither an interpretation nor an amendment to a standard was necessary and tentatively decided not to add this issue to its agenda. At the January 2016 meeting, the staff presented an analysis of the comments received on the tentative agenda decision, and further discussions took place.

In March 2016, the Committee reiterated its previous observation that the entity's liability for the prepaid card meets the definition of a financial liability. It also noted that customer loyalty programmes were outside the scope of its discussion on this issue. The Committee decided not to add this issue to its agenda.

IFRS 9: Transition issues relating to hedging

In January 2016, the IFRS Interpretations Committee discussed two hedge accounting issues relating to transition from IAS 39 to IFRS 9:

- whether an entity can treat a relationship as a continuing hedging relationship if the entity changes the hedged item from an entire non-financial item (as permitted by IAS 39) 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

IFRS 9 supports the use of hedge designations that are not exact copies of actual risk management in certain circumstances.

- whether an entity can continue with its original hedge designation of the entire non-financial item on transition to IFRS 9 when the entity's risk management objective is to hedge only a component of the non-financial item.

With regard to the first issue, the Committee noted that when an entity changes the hedged item in a hedging relationship from an entire non-financial item to a component of the non-financial item on transition to IFRS 9, it is required to do so on a prospective basis as described in paragraph 7.2.22 of IFRS 9. The Committee also noted that 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 the exceptions in paragraph 7.2.26 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 the second issue, the Committee observed that:

- paragraphs BC6.97, BC6.98 and BC6.100 of IFRS 9 support the use of hedge designations that are not exact copies of actual risk management ('proxy hedging') as long as 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 cases 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 entire non-financial items could continue on transition to IFRS 9 as long as they meet the qualifying criteria in IFRS 9.

The Committee decided not to add these issues to its agenda.

IAS 39: Separation of an embedded floor from a floating-rate host contract

In January 2016, the IFRS Interpretations Committee returned to a topic previously discussed in September 2015 – i.e. the following aspects of the application of the embedded derivative requirements of IAS 39 in a negative interest rate environment:

- 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 discussions considered comments received on the tentative decision from its September 2015 meeting and the staff's proposed amended wording for the final agenda decision. The Committee observed that:

- paragraph AG33(b) of IAS 39 should be applied to an interest rate floor in a negative interest rate environment in the same way as it would be applied in a positive interest rate environment;

- when applying paragraph AG33(b) of IAS 39, an entity should compare:
 - the overall interest rate floor – i.e. the benchmark interest rate plus contractual spreads and, if applicable, any premiums, discounts or other elements that would be relevant to the calculation of the effective interest rate – for the hybrid contract; with
 - the market rate of interest for a similar contract without the interest rate floor; and
- to determine the appropriate market rate of interest for the host contract, an entity is required to consider the specific terms of the host contract and the relevant spreads (including credit spreads) appropriate for the transaction.

The Committee noted that:

- paragraph AG33(b) of IAS 39 makes no distinction between positive and negative interest rates;
- paragraph AG33(b) of IAS 39 requires an entity to identify whether an embedded interest rate floor is closely related to a host debt contract and makes no reference to individual components of an embedded interest rate floor (such as the benchmark interest rate); and
- the term ‘market rate of interest’ is linked to the concept of fair value as defined in IFRS 13 and described in paragraph AG64 of IAS 39 as the rate of interest ‘for a similar instrument with a similar credit rating’.

The Committee also observed that, under IFRS 9, the observations in this agenda decision would equally apply to financial liabilities.

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

Measurement of interests in associates and joint ventures that, in substance, form part of the net investment

In March 2016, the IFRS Interpretations Committee continued its discussion on the interaction between IFRS 9 and IAS 28 *Investments in Associates and Joint Ventures* relating to measurement of long-term interests that, in substance, form part of the net investments in an associate or a joint venture and to which the equity method is not applied. The Committee will continue considering this topic at a future meeting.

IFRS 9: Determining hedge effectiveness for net investment hedges

In March 2016, the IFRS Interpretations Committee continued its discussion of whether the ‘lower of’ test that is required to measure the ineffectiveness of cash flow hedges should also be applied for net investment hedges. The Committee reconfirmed its tentative decision from November 2015 not to add this issue to its agenda.

IAS 32: Offsetting and cash-pooling

In March 2016, the IFRS Interpretations Committee continued its discussion of whether certain cash-pooling arrangements would meet the requirements for offsetting under IAS 32. In the context of the particular fact pattern submitted, the Committee made the following observations:

- the principles in paragraphs 46 and 47 of IAS 32 should be considered to assess whether, at the reporting date, there is an intention to settle the subsidiaries' bank account balances on a net basis or whether the intention is for the subsidiaries to use those individual bank account balances for other purposes before the next settlement date;
- to the extent that the group did not expect to settle its subsidiaries' period-end account balances on a net basis, it would be inappropriate for the group to assert that it had the intention to settle the entire period-end balances on a net basis;
- in other cash-pooling arrangements, a group's expectations in this regard may be different and judgement would be required to determine whether there was an intention to settle on a net basis; and
- entities should consider the relevant disclosure requirements.

The Committee reconfirmed its tentative decision from November 2015 not to add this issue to its agenda.

Insurance contracts project

New standard set for balloting

In February, the IASB instructed its staff to begin the balloting process for the forthcoming insurance contracts standard, paving the way for the final standard to be issued around the end of 2016.

In the meantime, the IASB will decide on the effective date and complete targeted external reviews to ensure that the wording in the standard is interpreted consistently with the Board's objectives.

For more information, see our [web article and visual guide](#).

The headaches of impairment

“There is no one-size-fits-all approach to producing forward-looking scenarios, and the level of sophistication required will vary across different entities and approaches.”

– **Jonathan Bingham,**
Financial Services,
KPMG in the UK

With less than two years until IFRS 9 becomes effective, most banks are engaged in the heavy lifting phase of their implementation projects: replacing their ‘old-style’ impairment models based on the measurement of incurred losses with new ones able to measure expected credit losses (ECL) – even those that may occur far in the future. Banks acknowledged from the start that this would require significant effort and adaptation of systems and models, but in December the IFRS Transition Resource Group for Impairment of Financial Instruments (ITG) had detailed discussion of the standard’s requirements on the use of economic scenarios, which raised expectations about model sophistication a number of notches.

By definition, estimating *expected* credit losses requires a view on possible future economic conditions and how these conditions will impact a portfolio’s credit quality. Some argue that the quality of estimates can always be improved by increasing the granularity of scenario analysis and the complexity of models and inputs. Others believe that this thinking leads to opaque, hard-to-control models that produce information that is difficult to understand and of dubious reliability and usefulness. The wise could say that neither view is completely right or wrong.

The ITG clarified in its December 2015 meeting that it expects both the assessment for moving exposures from 12-month to lifetime ECL and the measurement of such losses to be based on reasonable and supportable information that is available without undue cost and effort about a representative range of multiple economic scenarios and their probabilities.

This article provides a window into emerging practice in this complex area.

What the standard requires

ECL are measured in a way that reflects:

- an unbiased and probability-weighted estimate that is arrived at by evaluating a range of different outcomes;
- the time value of money; and
- reasonable supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions.¹

The accounting implication of these simple words is profound, particularly with regard to future economic conditions. The consideration of future economic scenarios and their impact on the future credit performance of a portfolio is referred to as ‘forward-looking information’ – this information should be:

- unbiased and probability-weighted; and
- reasonable and supportable.

1. Paragraph 5.5.17 of IFRS 9.

Unbiased and probability-weighted

'Unbiased' is generally understood to mean a neutral, balanced estimate that is neither overly prudent nor overly optimistic. The *Conceptual Framework for Financial Reporting* to IFRS refers² to neutral information as follows.

"A neutral depiction is without bias in the selection or presentation of financial information. A neutral depiction is not slanted, weighted, emphasised, de-emphasised or otherwise manipulated to increase the probability that financial information will be received favourably or unfavourably by users. Neutral information does not mean information with no purpose or no influence on behaviour. On the contrary, relevant financial information is, by definition, capable of making a difference in users' decisions."

The Basel Committee on Banking Supervision, in its *Guidance on Credit Risk and Accounting for Expected Credit Losses*³ (GCRAECL), clarified that it does not view the unbiased consideration of forward-looking information as speculative and it expects management to apply its experienced credit judgement to consider future scenarios and to take into account the potential consequences of events occurring or not occurring and the resulting impact on the measurement of ECL.

When measuring ECL, an entity need not identify every possible outcome; instead, the different outcomes should be weighted for the probability that they might occur. How to formulate and probability-weight possible outcomes will be a key judgement area. Outcomes may differ from bank to bank, depending on each bank's portfolio, the level of information available and management's view of the likely future evolution of economic conditions.

Reasonable and supportable

The standard's notion of 'undue cost and effort' is tied in with the related concept of 'reasonable and supportable information'. As the future horizon increases, the availability of detailed information decreases and the degree of judgement in estimating credit losses increases.

Impairment is an entity-specific measurement and so each entity should establish its own specific approach for identifying forward-looking information. The ITG noted that ECL should reflect expected, not unexpected, losses and are therefore not biased towards downturn scenarios like stress tests are.

A key point is that information is not deemed to be reasonable and supportable if the entity has an insufficient basis on which to make a reasonable estimate. However, banks are not expected to interpret this in a restrictive way, but to develop systems and processes able to use all reasonable and supportable information that is relevant.

2. In paragraph QC14.

3. Available on its [website](#).

December's ITG meeting clarifies the principles

At its December meeting, the ITG was asked to provide guidance on how entities should incorporate forward-looking information in their measurement of ECL – in particular, whether entities could use one single forward-looking economic scenario or should incorporate more than one economic scenario and, if so, how.

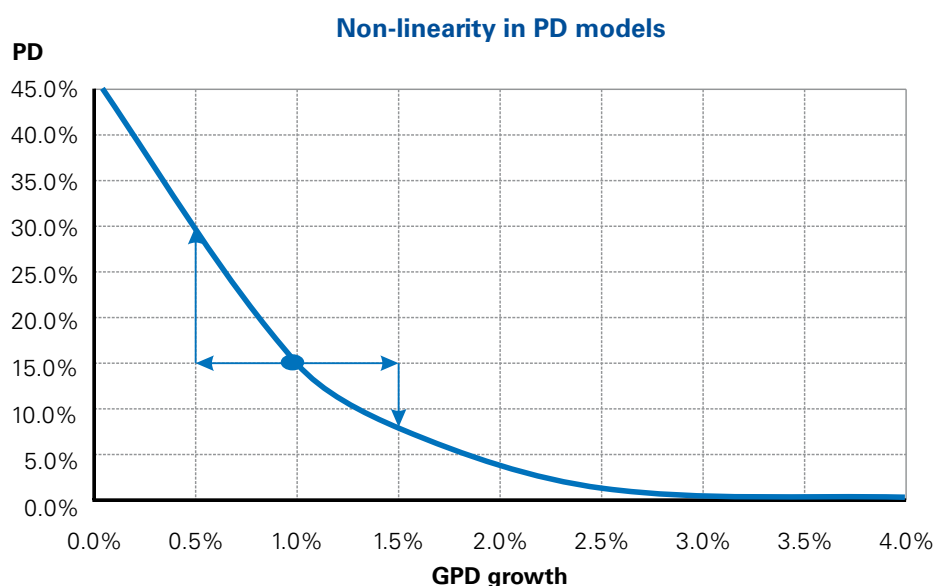
The ITG noted that basing the estimate of ECL on the results of only one macro-economic scenario – e.g. a single best estimate or using the mean of multiple parties' best estimates of inputs – would not achieve the objective of the standard if there is a non-linear relationship between the macroeconomic indicators in different possible scenarios and their associated credit losses. Intuitively, ECLs would not react proportionally to upward and downward movements in economic variables.

As a consequence of the ITG highlighting the impact of the requirements of the standard, entities that were planning to use a single forward-looking scenario may have to rethink their plans.

The problem of non-linearity

The ITG highlighted that using only one forward-looking economic scenario with no adjustments would not be able to capture non-linearity or idiosyncratic risk inherent in the measurement of ECL. This issue arises because the relationship between changes in macro-economic conditions (e.g. GDP growth, unemployment rate, real estate prices etc) and changes in the parameters used in the ECL calculation (e.g. probability of default (PD) and loss given default (LGD)) is generally not linear and not symmetrical between increases and decreases. This is particularly relevant when it comes to downside scenarios – i.e. when things get worse.

For example, in the diagram below, a 0.5 percentage point decrease in GDP growth (from a base case of 1.0 to 0.5 percent) leads to a 15 percentage points increase in PD (from 15 to 30 percent), whereas a 0.5 percentage point increase in GDP growth from (1.0 to 1.5 percent) leads to only a 7.5 percentage points decrease in PD (from 15 to 7.5 percent).



“There is great power in aligning impairment losses with the bank’s view of the future.”

In effect, using a single forecast scenario would ignore both the non-linear distribution of the sensitivities to forecast economic conditions and the non-linearity inherent in the product of the different parameters used in the model – e.g. PD x LGD.

In general, non-linearity raises many questions – e.g. how do you deal with non-linearity in PD models while maintaining one global set of scenarios? Does it require some manual adjustment in certain places? Is that appropriate? Is it feasible? Is it material? How would it be governed? How do you deal with more extreme or idiosyncratic events not otherwise reflected in historical or forecast information – e.g. a British exit from the EU, or significantly increased political and military tension between nations in a particular region?

The big dilemma: Sophistication vs understandability

There is no one-size-fits-all approach to producing forward-looking scenarios, and the level of sophistication required will vary across different entities and approaches. In its GCRAECL, the Basel Committee confirmed that banks will need to adopt sound ECL methodologies commensurate with the size, complexity, structure, economic significance and risk profile of their exposures. In general, the larger and more complex a portfolio or entity, and the larger and more volatile that ECL are expected to be, the more sophisticated an entity’s approach may need to be. Therefore, under certain circumstances a relatively simple approach may be sufficient, whereas in others a more complex and sophisticated one will be necessary.

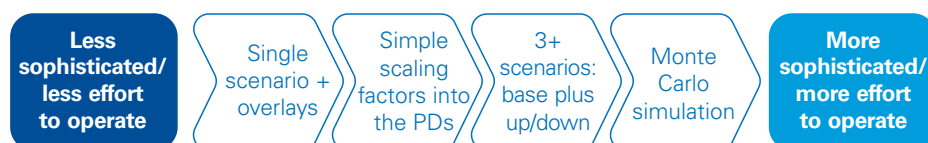
However, the size and complexity of a bank or portfolio are not the only factors to be considered in choosing an appropriate methodology for incorporating forward-looking information. Other elements to take into account are the complexity of products, the level of sophistication of models used for regulatory purposes (a bank using advanced regulatory models would be less justified in using simple models for ECL calculation), the availability of historical information and materiality considerations.

The possible approaches that in our experience are being most commonly discussed within the industry can in general be summarised as follows:

- overlay approaches;
- scenarios-based approaches; and
- Monte Carlo simulations.

In practice, the actual approaches may be a combination of the three above.

The level of sophistication can vary quite significantly and the diagram below shows this.



A possible drawback of a higher level of sophistication is that more effort may be required to design and operate internal controls over the use of the model and its inputs and to explain the model to senior management, audit committees, analysts and investors.

The mirage of simplicity

The production of just one scenario is sometimes considered simpler and operationally less complex, because it does not require explicit probability-weighting of alternative scenarios. However, this simplicity is largely an illusion because any sensible forecaster must inevitably consider the possibility of multiple future outcomes before unveiling his 'best estimate' and will acknowledge that its probability of occurrence is not 100 percent.

In fact, because the objective of IFRS 9 is to achieve an unbiased and probability-weighted estimate of ECL, an entity should consider the range of probabilities of different outcomes. Doing this – whether by applying an overlay to capture less likely scenarios or by scaling the different sensitivities into the PDs – would still require quite a high level of sophistication.

How many scenarios?

Using multiple scenarios seems to be more in line with the spirit of the standard. However, this approach would also raise questions over its implementation – e.g. how many scenarios? How to determine alternative scenarios? How to assign probabilities to the scenarios? Are any adjustments required?

Many say that a minimum of three representative scenarios should be explicitly modelled: a so-called base scenario, an upside scenario – e.g. when the parameters chosen (GDP, unemployment rate) perform better than expected – and a downside scenario. However, using even more scenarios may be appropriate, depending on the specific facts and circumstances, to ensure that the range of scenarios is representative and the results are unbiased. Whether a bank uses its own economic forecasts or third party estimates, it will not have to separately model every possible scenario and should avoid giving undue weight or bias to extreme scenarios.

Generally, the base scenario should use inputs consistent with those used for other internal reporting – e.g. budgeting, capital plans and forecasts. However, if those estimates represent management's target for future results and contain inherent optimism or are out of date, rather than representing a current neutral view of future economic conditions, then appropriate adjustments would be required.

Black box

The most computationally sophisticated of the planned approaches are based on the implementation of a very high number of scenarios – e.g. Monte Carlo simulations. A possible benefit of these models is that they may provide a wider range of possible outcomes. However, they can be costly to implement because they require a high degree of engineering.

The construction of complex multivariate distribution functions within such models may appear to provide greater objectivity; however, the reasonableness of these constructions depends on – and may need to be supplemented by – management's ability to input expert judgement into the process. Otherwise these highly sophisticated models, with their vast amounts of data (like aeroplane 'black boxes') may not meet the aim of IFRS 9. Also, management has to be able to understand the models and their assumptions and articulate this. This can be a significant challenge for management and requires proper governance and controls.

Governance and effective communication

The IAS 39 incurred loss model will be forever associated rightly or wrongly with 'too little, too late' accounting for impairment losses. The successful and transparent implementation of ECL accounting is vital for increasing trust in banks' accounts. Therefore, banks must invest in the right level of sophistication in – and internal controls over – their modelling and make sure that they can articulate this to regulators, investors and other stakeholders.

In many ways, IFRS 9's focus on entity-specific estimates of ECL that reflect the judgement of each bank's management bucks the trend of the regulatory capital regime, which is moving away from complex bespoke models. However, there is great power in the expected loss model when management aligns impairment losses with its view of the future – but this requires yet greater efforts on proper governance and clear communication with stakeholders. These efforts may have a much greater bearing on the success of IFRS 9 than how many economic scenarios are run in the black box.

How do you compare? Disclosure about the impacts of IFRS 9

The detail varied significantly from bank to bank.

The IASB issued IFRS 9 in July 2014, with an effective date of 1 January 2018. Early adoption is permitted, but in some jurisdictions – e.g. the EU – the standard has to be endorsed before it can be applied.

Users of financial statements are increasingly interested in understanding the impacts of IFRS 9. This article looks at how some banks are addressing this need.

What are banks required to disclose?

IAS 8 requires⁴ entities that have not applied a new standard or interpretation that has been issued but is not yet effective to disclose that fact and any known or reasonably estimable information relevant to assessing its possible impact in the year it is applied.

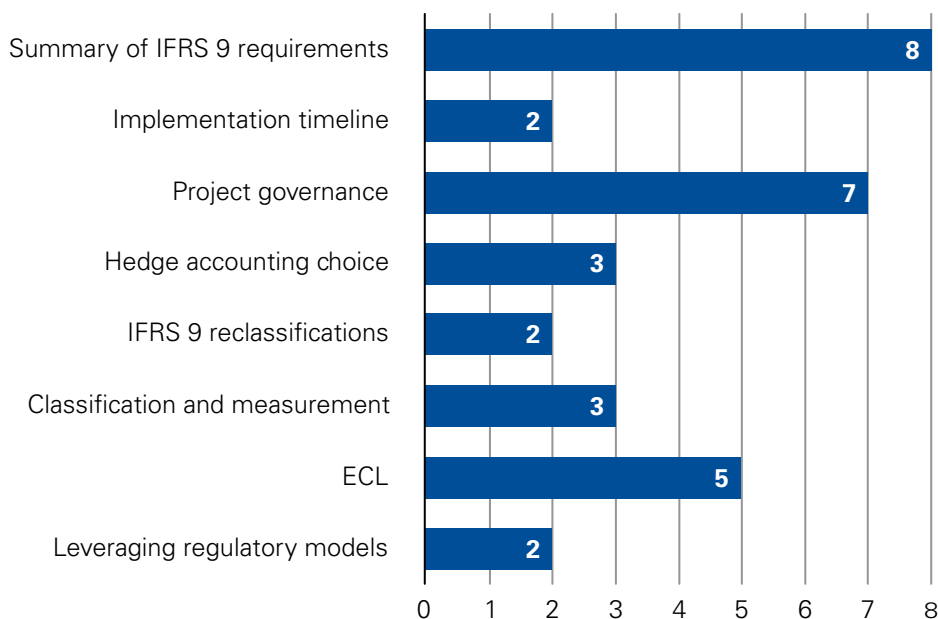
The Enhanced Disclosure Task Force, in its November 2015 report⁵ on implementing the ECL model of IFRS 9, stated that “a gradual and phased approach would be most useful to users”; adding that this approach would mean that “(a) the initial timing of information being provided, whether qualitative or quantitative, should be weighed against reliability; and (b) the nature and extent of disclosures will develop over time.”

What have banks disclosed so far?

We have looked at the 31 December 2015 accounts of eight major European banks reporting under IFRS.

All provided some information about IFRS 9, but the detail varied significantly from bank to bank. We have grouped the content of the disclosures into eight categories, as shown in the chart below.

What banks have disclosed



4. Paragraph 30 of IAS 8.

5. Available on its [website](#).

Summary of IFRS 9 requirements

All of the banks included in our sample described the key requirements of IFRS 9 – e.g. that it introduces new requirements for the classification and measurement of financial assets and financial liabilities, and the impairment of financial assets and hedge accounting. Some provided more detailed explanations, including the business model and the ‘solely payments of principal and interest’ (SPPI) criteria for classification and measurement, as well as the stage allocation of the new expected loss impairment model.

Implementation timeline

Two banks disclosed summary timelines for their implementation projects. Both planned to carry out implementation work during 2016–17 and a parallel run in 2017. One explained that 2015 was mainly dedicated to assessing the impact of the classification and measurement requirements, whereas its programme for 2016 will mainly focus on developing the impairment models, to be completed by the end of the year. The other disclosed that during 2015 its project focused on an impact assessment of the classification and measurement and impairment requirements.

Project governance

Most of the banks in our sample disclosed that they have set up dedicated infrastructure for implementing IFRS 9. This typically includes a central management team and a number of working groups and work streams. Some banks explained how the project had been structured in terms of governance and different tasks assigned to working groups.

Three banks disclosed that the project is led jointly by their risk and finance departments.

Hedge accounting choice

IFRS 9 includes an accounting policy choice allowing entities to defer application of the new general hedging model until the standard resulting from the IASB’s project on accounting for dynamic risk management becomes effective. Three banks mentioned the existence of this choice. One disclosed that it expects to continue to apply hedge accounting under IAS 39. The other two said that they were still considering the option.

IFRS 9 reclassifications

One bank disclosed how the classification and measurement of its financial assets will change on transition to IFRS 9:

- loans and receivables to customers and banks, and non-trading reverse-repurchase agreements that are classified as loans and receivables under IAS 39 will be measured at amortised cost under IFRS 9;
- debt securities classified as held-to-maturity will be measured at amortised cost;
- debt securities classified as available-for-sale will primarily be measured at amortised cost or fair value through other comprehensive income (FVOCI), with a small minority at fair value through profit or loss (FVTPL) either because of their contractual cash flow characteristics or because of the business model within which they are held;
- treasury and other eligible bills classified as available-for-sale will be measured at amortised cost or FVOCI depending on the business model in which they are held;

- financial assets designated at FVTPL will remain at FVTPL, either because it is required under IFRS 9 or because designation will continue; and
- all equity securities will remain measured at fair value. A significant majority will have fair value movements shown in profit or loss, and a minority will have fair value movements presented in other comprehensive income.

Classification and measurement

Two banks stated they were not expecting significant impact in this area and that the measurement basis of the majority of their financial assets should remain unchanged.

ECL

Most of the banks sampled provided some directional impact of implementing the ECL model. The majority reported that it will result in an increase or a material increase in the total level of impairment. One bank disclosed that it expected an increase in volatility. One reported that the impact on capital would be mitigated by the 'excess of expected losses over impairment' included in the CET1 calculation.

No bank provided quantitative information. However, one did say that it planned to disclose quantitative information on the adoption of IFRS 9 no later than in its 2017 annual accounts.

Leveraging regulatory models

Two banks stated that they intend to leverage their Basel ECL models to generate IFRS ECL numbers. Both noted differences between IFRS 9 and the regulatory requirements.

One bank disclosed its intention to align the definition of 'default' with the regulatory definition as far as possible, except for retail portfolios for which the regulatory definition of default is set at 180 days past due.

Other information

One bank provided further insight on its application of the impairment requirements of IFRS 9, including criteria to be used to assess whether a loan is credit-impaired, a rebuttable presumption that a loan in arrears by more than 90 days is in default, the impact of a modification of contractual terms, significant increase in credit risk, aligning the definition of default for IFRS 9 with the regulatory definition and differences with regulatory requirements.

Regulation in action: More change on client clearing for OTC derivatives

“Clearing member banks that move from CTM to STM contracts as a result of the LCH rule book changes need to determine whether they can continue hedging relationships that involve converted CTM contracts”.

– **Mike Hall,**
Department of Professional
Practice, KPMG in the US

In the [Q3 2015](#) issue of *The Bank Statement*, we discussed how client clearing of over-the-counter (OTC) derivatives can impact the size of a bank's balance sheet. One of the reasons for this impact is the requirement of central clearing counterparties (CCPs) that their clearing members post cash variation margins (VM).

As previously discussed, if making the VM payments and receipts:

- represents a partial settlement of contractual rights under the relevant derivative contracts, then the corresponding amount of derivative is derecognised; or
- relates to a VM balance that is a separate financial asset or financial liability, then the recognised VM balance is adjusted but the related derivative is not.

We also noted that in February 2015 the Chicago Mercantile Exchange (CME) filed a notice with the SEC stating that the CME was clarifying that the payment of VM within its daily settlement process results in the derivative exposure being settled on a daily basis. Clearing member banks are still considering the impact of this clarification. CME rule clarifications on the payment of VM as settlement are expected in 2016.

This article provides an update on recent developments. Separate accounting matters relating to initial margin are not considered here.

Rule book changes by LCH.Clearnet

In December 2015, LCH.Clearnet (LCH) made changes to its rule book. The changes give SwapClear clearing members the option to amend their existing and new interest rate swap agreements from collateral-to-market (CTM) contracts to settled-to-market (STM) contracts. The rule changes apply to SwapClear clearing members that elect to convert all of their house/proprietary positions. This is different from the CME, whose rule changes apply to all clearing members and all new and existing agreements.

LCH has structured STM interest rate swap contracts so that all of the outstanding exposure that is calculated for the contract is settled daily and the outstanding exposure of the contract is reset to zero daily. Once a clearing member bank elects to convert its house/proprietary positions at LCH, the election cannot be reversed.

The LCH rule book refers to the change from CTM to STM as a modification rather than termination of the existing contract.

Future rule book changes could allow the conversion of client clearing (end user) transactions by SwapClear clearing members and the conversion of contracts by futures commission merchants. Futures commission merchants are direct clearing members of LCH that can clear proprietary business, US-domiciled (i.e. trades under New York law) client business and non-US-domiciled client business. The futures commission merchant membership type was added by LCH to meet the requirements of the *Commodity Exchange Act*, which requires clients domiciled in the US to clear through entities registered with the US Commodity Futures Trading Commission as futures commissions merchants.

Clearing member banks, accounting firms and regulators are focusing on the LCH changes due to their possible impact on clearing member banks' balance sheets and capital requirements.

How are CTM and STM contracts different?

CTM contracts	<ul style="list-style-type: none">– Parties are periodically obliged to transfer collateral assets equal to mark-to-market exposure to the other party.– Exposure is not reset or extinguished by the transfer of collateral.– Exposure remains in existence but is collateralised by the transferred cash and both are subject to netting arrangements.– Any interest earned on collateral (referred to as 'price alignment interest') is owed to the party that posted collateral.
STM contracts	<ul style="list-style-type: none">– LCH determines the current exposure value each day. This amount becomes separately due and payable.– The exposure (net present value) of the contract resets to zero daily immediately following this determination by LCH. Amounts due and payable are extinguished by payment.– Parties receive the equivalent of price alignment interest as price alignment adjustment. Payments for price alignment adjustment are determined based on cumulative VM payments made to settle outstanding exposure and are considered part of the derivative instrument.

IAS 39 derecognition

When a clearing member bank elects to convert a CTM contract into an STM contract, it may need to consider whether the change in contractual terms means that – for accounting purposes – the CTM contract should be derecognised and the STM contract should be recognised as a new contract.

IAS 39 requires derecognition of a *financial asset* when the contractual rights to the cash flows from the financial asset expire, and derecognition of a *financial liability* when it is extinguished.

Any substantial modification of the terms of an existing financial liability needs to be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. A similar approach usually applies for modifications of financial assets.

Derivatives such as interest rate swaps involve two-way payments between counterparties and may change between asset and liability classification. Because of this, entities should only derecognise interest rate swaps when the derecognition criteria for both financial assets *and* financial liabilities are met.

The debate continues whether the conversion of a CTM contract to an STM contract results in the termination of the CTM contract due to a substantial modification of the terms. Careful consideration needs to be given to the economic and legal differences between the terms of the two contracts. If it is concluded that the terms of the CTM contract and STM contract are substantially different, then derecognition will be appropriate.

Hedging relationships

A conclusion that derecognition of a hedging derivative is appropriate generally leads to the discontinuance of the current hedging relationship, unless a replacement or rollover of a hedging instrument into another hedging instrument is part of an entity's documented hedging strategy.

Clearing member banks that move from CTM to STM contracts as a result of the LCH rule book changes need to determine whether they can continue hedging relationships that involve converted CTM contracts. In carrying out this analysis, they should consider the guidance in paragraph 91 of IAS 39. Prospective discontinuance is generally required when a hedging instrument expires or is sold, terminated or exercised, or if the hedging relationship no longer meets the criteria for hedge accounting in paragraph 88 of IAS 39.

If the hedging relationship involving a CTM contract is discontinued, then a clearing bank would have to consider whether the new STM contract could be designated as a hedging instrument in a new relationship. If so, then the clearing member bank would have to establish formal documentation at the inception of this new hedging relationship, including describing how hedge effectiveness will be assessed.

Clearing member banks should also consider the impact of price alignment adjustment on recognising changes in the fair value of settled derivatives. Entities that attribute price alignment interest to the derivative in a CTM contract will probably see no change in the fair value of the derivative due to price alignment adjustment being incorporated into the STM contract. For these entities, ineffectiveness presumably currently exists in the hedging relationship. For entities that are not currently attributing price alignment interest to the derivative in a CTM contract, considering it a part of the STM derivative instrument will affect the overall changes in fair value of the derivatives, and in some cases may lead to the hedging relationship no longer being effective.

Dialogue continues on the conversion from CTM contracts to STM contracts and the impact on hedging relationships.

The road ahead

Industry and regulatory consensus will probably build around the appropriate accounting conclusions for clearing member banks regarding the LCH rule book changes. Accounting analyses related to financial instruments and hedging can be time-consuming and complex. There will be specific facts and circumstances to consider as clearing member banks determine the impact of the rule book changes. This may require the involvement of operations, legal and accounting specialists.

Where regulation and reporting meet...

The Basel Committee issued a new consultative document for comments, which forms the second phase of the Pillar 3.

The Basel Committee continues to shape Pillar 3 disclosures

In the [Q4 2015](#) issue of *The Bank Statement*, we discussed the evolving disclosure requirements under both the *Basel Framework* and IFRS 7 *Financial Instruments: Disclosures*. We noted that revised disclosure requirements were issued by the Basel Committee in January 2015, which completed the first phase of its review of Pillar 3.

In March 2016, the Basel Committee issued a new consultative document for comments, *Pillar 3 disclosure requirements – consolidated and enhanced framework* (the proposals), which forms the second phase of the Pillar 3 review.

This phase of the review includes new templates and covers:

- enhancements to the revised Pillar 3 framework:
 - dashboard metrics;
 - use of standardised approaches to benchmark internally modelled capital requirements; and
 - prudent valuation disclosure requirements;
- further revisions and additions to the Pillar 3 framework arising from ongoing reforms to the regulatory policy framework:
 - G-SIIB disclosure requirements for total loss-absorbing capacity;
 - updated disclosures to align with the finalisation of operational risk and market risk requirements; and
 - interest rate risk in the banking book; and
- the consolidation of all existing and prospective Basel Committee disclosure requirements into the Pillar 3 framework – for example:
 - composition of capital;
 - Basel III capital requirements and leverage ratio;
 - Basel III liquidity and net stable funding ratio requirements; and
 - remuneration.

Unless otherwise specified, all disclosure requirements in the proposals apply to internationally active banks at the top consolidated level.

The proposed frequency of disclosures varies between quarterly, semi-annual and annual. A bank's Pillar 3 report should generally be published concurrently with its financial report for the corresponding period.

The suggested implementation dates for the proposed disclosure requirements are:

- for minor proposed changes: a bank's 2017 financial year end; and
- for proposed changes that are dependent on the implementation of another policy framework, the proposed implementation date has been linked to the implementation of that other framework.

The comment period expires on 10 June 2016⁶.

6. Find out more on the BIS [website](#).

You may also be interested to read...

Insights into IFRS: 12th Edition 2015/16



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

September 2015

IFRS Newsletter: Financial Instruments – Issues 27 and 28



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

October 2015 and February 2016

First Impressions: IFRS 9 *Financial Instruments*



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

September 2014

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 – Issues 51 and 52



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

January and March 2016

Click on the images above to access the publications.

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