# THE BANK STATEMENT

Q4 2013 NEWSLETTER

KPMG
*cutting through complexity*

> "IFRS 10 contains a single consolidation model that applies to all investees (operating entities and structured entities). Application of this principle to the specific facts and circumstances often requires the exercise of significant judgement."

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## GENERAL HEDGE ACCOUNTING MODEL RELEASED AND IFRS 10 LESSONS FROM FIRST YEAR OF APPLICATION OUTSIDE EU

Welcome to the Q4 2013 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**

- The IASB issued a **new general hedge accounting model** – part of IFRS 9 *Financial Instruments* (2013) – which will align hedge accounting more closely with risk management – see page 2.
- The mandatory effective date for the application of IFRS 9 *Financial Instruments* will be **no earlier than annual periods beginning on or after 1 January 2017** – see page 2.
- Deliberations continue on some of the key aspects of the IASB's proposals for **expected credit losses and classification and measurement** to form part of the future financial instruments standard – see pages 2 and 3.
- Non-EU banks have already applied **IFRS 10 *Consolidated Financial Statements***, which is effective for annual periods beginning on or after 1 January 2013. We discuss some of the **learning points from the first year of implementation** – see page 7.
- The European Central Bank is to perform an asset quality **review of the eurozone's** most significant 130 banks. We consider some possible accounting implications – see page 11.

# IASB ACTIVITIES AFFECTING YOUR BANK

## General hedge accounting model released

On 19 November 2013, the IASB issued a new general hedge accounting model – part of IFRS 9 *Financial Instruments* (2013) – which will align hedge accounting more closely with risk management. The new standard does not fundamentally change the types of hedging relationships or the requirement to measure and recognise ineffectiveness; however, under the new standard more hedging strategies that are used for risk management will qualify for hedge accounting.

The new standard allows an entity to change the accounting for financial liabilities that it has elected to measure under the fair value option, without applying any of the other requirements in IFRS 9. With that change, gains and losses resulting from an entity's own credit risk are recognised outside profit or loss.

For more information, see our publication First Impressions: IFRS 9 (2013) – Hedge accounting and transition.

## Macro hedging discussions completed

In October 2013, the IASB confirmed that it has completed all of the necessary steps to ensure that the *Accounting for Macro Hedging* discussion paper is likely to meet its purpose. It instructed the staff to prepare a draft for ballot and decided that the comment period should be 180 days.

The IASB's target date for publishing the discussion paper *Accounting for Macro Hedging* is Q1 2014.

## Mandatory effective date of IFRS 9 removed

As part of the amendments to IFRS 9 released on 19 November 2013, the IASB has removed the 1 January 2015 effective date of the standard. The new mandatory effective date will be determined once the classification and measurement and impairment phases of IFRS 9 are finalised.

However, to help entities in their planning, the IASB on 21 November 2013 tentatively decided that the mandatory effective date of IFRS 9 would be no earlier than annual periods beginning on or after 1 January 2017.

## Impairment: IASB continues to shape model

The IASB continued to discuss the impairment model and many requirements in ED/2013/3 *Financial Instruments: Expected Credit Losses* (the impairment ED) were reconfirmed. In addition, the IASB tentatively agreed to provide clarifications, application guidance and examples in some areas.

The key areas in which the IASB made tentative decisions to amend or refine proposals in the impairment ED are as follows.

- *Timing of recognition of lifetime expected credit losses:* The assessment of significant increases in credit risk could be implemented more simply by establishing the initial maximum credit risk for a particular portfolio of financial instruments with similar credit risk on initial recognition (by product type and/or region) and then comparing the credit risk of financial instruments in that portfolio at the reporting date with the origination credit risk.
- The proposed description of low credit risk would be modified.
- The expected credit losses would be discounted at the effective interest rate or an approximation thereof.
- For revolving credit facilities:
  - expected credit losses would be estimated for the period over which an entity is exposed to credit risk and over which future drawdowns cannot be avoided;
  - expected credit losses on the undrawn and drawn portions of the facility would be discounted using the same effective interest rate (EIR), or an approximation thereof; and

- the provision for the expected credit losses on the undrawn facility would be presented together with the loss allowance on the drawn facility if an entity cannot separately identify these two components.

- For other loan commitments and financial guarantee contracts:
  - expected credit losses on the undrawn and drawn portions of the facility would be discounted using the same EIR, or an approximation thereof, unless the EIR cannot be determined; and
  - the provision for the expected credit losses on the undrawn facility would be presented together with the loss allowance on the drawn facility if an entity cannot separately identify these two components.
- *Transition:* An entity could approximate the credit risk on initial recognition by considering the best information that is available without undue cost or effort. If an entity was not able to determine or approximate the credit risk on initial recognition, then it would measure the loss allowance based on the credit quality at each reporting date until that financial instrument is derecognised.

The IASB will decide at a future meeting whether to finalise the ED. The IASB's target date to issue the final standard is the first half of 2014.

## Classification and measurement

The IASB continued to discuss the classification and measurement model. Its tentative decisions included the following.

### Meaning of the business model

- The term 'business model' should refer to the way in which financial assets are managed.
- The business model assessment should result in financial assets being measured in a way that would provide the most relevant and useful information.
- The business model should be assessed at a level that reflects groups of financial assets that are managed together to achieve a particular objective.
- The final standard would make the following clarifications.
  - The business model is often observable through particular activities that are undertaken to achieve the objectives of that business model.
  - These business activities usually reflect the way in which the performance of the business is evaluated and reported, as well as the risks that typically affect the performance of the business model; and how those risks are managed.
  - An entity should consider all relevant and objective information, but not every 'what if' or worst-case scenario.
  - The application guidance in the final standard would include the following clarifications.
    - Sales do not drive the business model assessment.
    - Historical sales information would help an entity support and verify its business model assessment.
    - Fluctuations in sales in a particular period do not necessarily mean that the entity's business model has changed.
    - If cash flows are realised in a way that is different from the entity's expectations, then this would neither result in the restatement of prior-period financial statements nor change the classification of the existing financial assets in the business model as long as the entity considered all relevant and objective information that was available at the time that it made its decision.

- A change in business model would occur only when an entity has either stopped or started doing something on a level that is significant to its operations. This would generally be the case only when the entity has acquired or disposed of a business line.
- Held-to-collect business model:
  - The current held-to-collect 'cash flows (value) realisation' concept would be reinforced by providing examples and guidance.
  - Insignificant and/or infrequent sales may be consistent with the held-to-collect business model, regardless of the reasons for those sales.
  - Historical sales information and patterns could provide useful information, but this sales information would not be determinative.
  - Sales to minimise potential credit risk due to credit deterioration are integral to the held-to-collect objective.
  - Sales made in managing concentrations of credit risk would be assessed in the same way as any other sales made in the business model.

### FVTPL measurement category

- The fair value through profit or loss (FVTPL) measurement category would be retained as the residual category and the final standard would clarify the following.
  - When financial assets are either held for trading or managed and evaluated on a fair value basis, the entity makes decisions about whether to hold or sell the assets based on changes in, and with the objective of realising, the assets' fair value.
  - The activities that the entity undertakes are primarily focused on fair value information, and key management personnel use that information to assess the assets' performance and to make decisions accordingly.
  - Another indicator is that the users of the financial statements are primarily interested in fair value information on these assets to assess the entity's performance.

### FVOCI category

- The final standard would clarify the following in respect of the fair value through other comprehensive income (FVOCI) category.
  - Managing financial assets both to collect contractual cash flows and for sale would reflect the way in which financial assets are managed to achieve a particular objective, rather than the objective in itself.
  - The application guidance would more clearly articulate that FVOCI provides relevant and useful information when both the collection of contractual cash flows and the realisation of cash flows through selling are integral to the performance of the business model.
  - The application guidance would describe activities that are typically associated with such a business model.
  - There would be no threshold for the frequency or amounts of sales.
- It was reconfirmed that entities would be permitted to apply the fair value option to a financial asset that would otherwise be mandatorily measured at FVOCI if such a designation eliminates or significantly reduces an accounting mismatch.

### Next steps

The IASB will consider the remaining aspects of its proposals at a future meeting, with the aim of issuing amendments to IFRS 9 in the first half of 2014.

## Fair value measurement: Unit of account

In its December 2013 meeting, the IASB discussed the application of the portfolio exception as set out in IFRS 13 *Fair Value Measurement* for portfolios that comprise only Level 1 financial instruments whose market risks are substantially the same.

The IASB tentatively decided that the measurement should be calculated by multiplying the net position by the Level 1 prices.

It also tentatively decided that the exposure draft that clarifies the fair value measurement of quoted investments in subsidiaries, joint ventures and associates should include a non-authoritative example to illustrate the application of the portfolio exception for a portfolio that comprises only Level 1 financial instruments whose market risks are substantially the same.

## Applicability of IFRS 7 offsetting disclosures to condensed interim financial statements

As discussed in the Q3 2013 issue of *The Bank Statement,* the IASB has been considering a recommendation from the IFRS Interpretations Committee to clarify the applicability to condensed interim financial statements of the new offsetting disclosures required by the amendments to IFRS 7 *Financial Instruments: Disclosures.*

In its October 2013 meeting, the IASB noted that it did not amend IAS 34 *Interim Financial Reporting* when it issued the amendments to IFRS 7. Consequently, the additional disclosures required by the amendments to IFRS 7 are not required in condensed interim financial statements unless their inclusion would be required in accordance with the existing requirements of IAS 34.

Given the uncertainty about this matter, the IASB tentatively decided to propose amendments to IFRS 7 to clarify the requirements. The proposed amendments were included in the exposure draft *Annual Improvements 2012–2014 Cycle* (see our IFRS Newsletter: The Balancing Items).

## Applicability of IFRS 7 disclosures for transferred financial assets to servicing contracts

In the Q3 2013 issue of *The Bank Statement,* we also noted that the IASB has been considering a recommendation from the IFRS Interpretations Committee that it should propose an amendment to IFRS 7 to clarify whether a servicing contract is continuing involvement for the purposes of the transfer disclosure requirements in paragraphs 42A–42H of IFRS 7. In its October 2013 meeting, the IASB decided to include the following amendment in the exposure draft *Annual Improvements 2012–2014 Cycle*:

- add guidance to IFRS 7 on determining whether a servicing right is continuing involvement for the purposes of the transfer disclosure requirements;
- not require comparative information; and
- amend IFRS 1 *First-time Adoption of International Financial Reporting Standards* to provide first-time adopters with the same transition relief.

## Identification of a present obligation to pay a levy that is subject to a pro rata activity threshold as well as an annual activity threshold

IFRIC 21 *Levies* was issued by the IASB in May 2013 and is effective for annual periods beginning on or after 1 January 2014. The IFRS Interpretations Committee received a request to clarify how the requirements in paragraph 8 of IFRIC 21 should be interpreted in identifying an obligation event for a levy.

In its November 2013 meeting, the Committee discussed regimes in which an obligation to pay a levy arises as a result of activity during a period but is not payable until a minimum activity threshold, as identified by the legislation, is reached. The threshold is set as an annual threshold, but this threshold is reduced, pro rata to the number of days in the year that the entity participated in the relevant activity, if its participation in the activity started or stopped during the course of the year. The request asked for clarification on how the thresholds stated in the legislation should be taken into consideration when deciding "the activity that triggers the payment of the levy" in paragraph 8 of IFRIC 21.

The Committee noted that in the fact pattern provided the payment of the levy was triggered by reaching the annual threshold as identified by the legislation; and the entity would be subject to a threshold that is lower than the threshold that applies at the end of the annual assessment period if, and only if, the entity stops the relevant activity before the end of the annual assessment period. Accordingly, the Committee observed that in the light of the guidance in paragraph 12 of IFRIC 21, the obligating event for the levy is the reaching of the threshold that applies at the end of the assessment period.

The Committee thought that the guidance in IFRIC 21 and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* is sufficient and noted that it is unlikely that significant diversity in interpretation on this issue will emerge. Accordingly, the Committee decided not to add this issue to its agenda.

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## Investment entities: Investment entity subsidiary that provides investment-related services

In its November 2013 meeting, the IFRS Interpretations Committee considered the accounting by an investment entity for an investment entity subsidiary that also provides investment-related services. The issue is whether such a subsidiary should be measured at fair value (because it meets the definition of an investment entity) or consolidated (because it provides investment-related services).

The Committee decided to add this issue to its agenda and will consider a proposed amendment to IFRS 10 *Consolidated Financial Statements* at a future meeting.

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## Investment entities: Exemption from preparing consolidated financial statements

Also in its November 2013 meeting, the IFRS Interpretations Committee received a request to clarify whether the exemption set out in paragraph 4 of IFRS 10 – namely that an intermediate parent need not present consolidated financial statements – is available to entities that, as a result of the investment entities amendments, are measured at fair value in the consolidated financial statements of their parent entity.

The Committee observed that an intermediate parent that does not provide investment-related services is included in its investment entity parent's financial statements at fair value, and not through consolidation. The Committee questioned whether it was appropriate for such an intermediate parent to qualify for the exemption from the requirement to prepare consolidated financial statements if the intermediate parent was not, itself, an investment entity.

The Committee will discuss this matter at a future meeting.

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# IFRS 10: LESSONS LEARNED FROM THE FIRST YEAR OF APPLICATION

> "Even if the consolidation conclusion remained the same, the analysis necessary to reach that conclusion required significant data collection, judgement and documentation for each material investee."

**Editorial by Angie Ah Kun and Tara Smith, Department of Professional Practice, KPMG in South Africa**

Because IFRS 10 became effective for annual periods beginning on or after 1 January 2013 in non-EU jurisdictions, non-EU banks have now applied it in both their interim and annual financial statements. This article discusses some of the learning points from the first year of implementation.

IFRS 10 contains a single consolidation model that applies to all investees (operating entities and structured entities). The model is based on the fundamental principle of control, which involves power, exposure to variability of returns and a linkage between the two. Application of this principle to the specific facts and circumstances often requires the exercise of significant judgement. Banks had to reassess existing relationships with investees at the date of initial application of the standard – i.e. the beginning of the annual reporting period for which IFRS 10 is applied for the first time. Not all investees required an in-depth analysis. If the bank was a majority shareholder, no other parties had substantive rights and there were no complex governance arrangements, then little further analysis was required. Banks that had funds and asset management businesses, as well as securitisations and other structures, needed more analysis.

## *Overall findings*

- For many securitisation vehicles, the consolidation conclusion did not change. However, the analysis necessary to reach that conclusion required significant data collection, judgement and documentation for each material investee.
- In some cases, banks ceased consolidating securitisation vehicles that were previously consolidated. This necessitated a derecognition analysis for securitised assets.
- The main area in which the conclusions changed was in the fund management business of a bank, often resulting in additional investees being consolidated. Exposure to variability sometimes arose through the bank providing guarantee protection to third parties over the fund's assets.

## *Areas of particular note*

| Lessons learned | Practical implications and examples |
|---|---|
| ***Purpose and design of investee*** | |
| It is important to understand fully what the investee has been set up to do. Although we would previously have described the new control model as a three-step approach[1], we have come to view it as a four-step model, with assessing the purpose and design of the investee being a key part of the first step (understanding the investee). | Information about purpose and design can be obtained from various sources, including:<br>• the investee's founding charter;<br>• business plans;<br>• annual reports;<br>• acquisition-related documents – circulars, prospectuses and purchase agreements;<br>• profit-sharing arrangements; and<br>• outsourcing arrangements. |

1 The three steps consist of assessment of power over relevant activities, exposure to variability of returns, and a linkage between power and returns.

| Lessons learned | Practical implications and examples |
|---|---|
| ***Purpose and design of investee (continued)*** | |
| The focus should be on the risks that the investee was designed to create and to pass on to other parties. Bearing in mind the subjectivity involved in the control assessment, it is crucial to understand the economic relationship between the investor and investee and the substance (rather than legal form) of the arrangement. This step is a filter through which the control model is applied. | |
| Both quantitative *and* qualitative returns should be considered when assessing control and the linkage between power and returns. The purpose and design often give an indication of qualitative returns.<br><br>An investor's exposure to variability in returns is usually easy to prove because there is no minimum threshold and the concept of returns is very broad. | For example, in securitisation structures, qualitative returns include access to liquidity and management of customer relationships. |
| ***Relevant activities*** | |
| The activities that significantly affect the investee's – not the investor's – returns are those that involve active decision making and that occur after an entity has been set up. | Although they are not conclusive on their own, decisions such as establishing and approving operating and capital budgets and appointing, remunerating and terminating key management personnel of the investee are often key to this analysis. |
| In some structures – e.g. securitisations – relevant activities often take place on the occurrence of a particular event and may take place outside the investee. They are still relevant activities of the investee because they are integral to the investee's purpose and design, and affect the investee's returns. In our experience, it is rare for an investee to have no relevant activities such that no investor consolidates it. | For example, on default of receivables sold to a structured entity, the management of recoveries sometimes remains with the originator of the receivables. |

| Lessons learned | Practical implications and examples |
|---|---|
| ***Protective rights*** | |
| Protective rights cannot give their holder power over relevant activities or prevent other parties from having power. However, protective rights can become exercisable when certain events or conditions occur and will result in a reassessment of the control conclusion at that time. | For example, in troubled debt scenarios, banks often obtain decision-making powers when a borrower breaches a loan covenant. The bank may have:<br>• a pledge over the shares or assets of the borrower;<br>• a right to assign rights and claims under the borrower's supply agreement with an operator; or<br>• a right to veto a change in ownership of the borrower.<br>These rights are protective before the breach, but may give the bank power after the breach. |
| ***Potential voting rights*** | |
| The focus is no longer on whether potential voting rights are currently exercisable, but rather on whether they are substantive. | For example, a bank may have a call option that becomes exercisable in the event of deadlock between it and another party. On exercise, it would have the ability to make decisions unilaterally. This contingency – i.e. deadlock – does not limit the power associated with the option because it relates to decision making and is exercisable when it is actually needed.<br>The bank would determine whether there are any barriers that would prevent exercise of the option and result in it not being substantive. |
| ***Structured entities*** | |
| If voting rights are not relevant to the analysis – i.e. relevant activities are directed through contractual or other arrangements – then the evidence of practical ability to direct the relevant activities is generally given the greatest weighting in the control analysis. In assessing who has power over a structured entity set up by a bank, it is important to establish who has the practical ability to direct the relevant activities. The focus is no longer on which party has the majority of rewards or bears the residual ownership risks. | For example, a structured entity is set up by a bank to provide funding to specific entities related to a corporate. It is nominally capitalised 80% by the bank and 20% by the corporate. The bank also provides debt financing. Under SIC-12 *Consolidation – Special Purpose Entities* (which has been replaced by IFRS 10), the bank may have consolidated the structured entity based on its exposure to a majority of the residual risks.<br>Under IFRS 10, the corporate may have to consolidate the structured entity if it uses its power over the relevant activities of the structured entity to affect its returns. |

| Lessons learned | Practical implications and examples |
|---|---|
| ***Linkage between power and returns*** | |
| The default presumption for investees controlled by voting rights is that the linkage test is met – i.e. exposure to variability of returns is correlated with the amount of power.<br><br>However, for structured entities, further analysis of the linkage between power and returns is required. Such analysis involves consideration of whether the power is exercised in the capacity of a principal or agent. When assessing whether a fund manager is acting as an agent or principal, the analysis usually includes a quantitative assessment of the fund manager's aggregate economic interest. The key measure is variability – i.e. how much the fund manager's total income varies as the fund's performance varies.<br><br>To assess banks' involvement with structured entities other than funds, it is often necessary to assess the linkage between power and returns using a quantitative and qualitative analysis taking into account all sources of returns. Also, it is important to establish if a decision maker's exposure to variability in returns is different from that of other investors, because this may influence its actions. | Interpreting the results of the quantitative measure of aggregate economic interest requires judgement. The IASB provides examples of when a level of variability indicates that the entity is clearly an agent or clearly a principal. The challenge for banks is to draw conclusions when the level of variability falls between these points. In many cases, indicators of the significance of the right of others to remove the bank as fund manager may be unclear.<br><br>In a securitisation structure, the party that issues a guarantee for certain losses on assets securitised will be incentivised to exercise any power that it has to keep losses out of the guaranteed zone. The linkage between power and returns is then better assessed taking into account qualitative factors, which requires judgement. |

## *Reminder: Also consider IFRS 12 requirements for structured entities*

IFRS 12 *Disclosure of Interests in Other Entities* is effective for annual periods beginning on or after 1 January 2013. It sets out disclosure requirements for consolidated and unconsolidated structured entities, and therefore is of particular relevance to banks because they often have interests in or sponsor numerous structured entities such as securitisation vehicles, funding conduits and investment funds.

Among a number of new disclosure requirements introduced by the standard is the requirement to disclose information about entities' involvement with and sponsorship of structured entities (even if the structured entities are not controlled). This may require significant effort and data collection, especially if financial or other support has been or will be provided to the structured entity.

Often the issues to consider in practice relate to defining a sponsored entity and assessing whether the funding provided to structured entities can be seen as part of the normal supplier-customer relationship, which does not affect the consolidation conclusion.

# REGULATION IN ACTION: ECB ASSESSMENT LIKELY TO STRESS ACCOUNTING FIGURES

## What is the ECB planning to do?

In October 2013, the European Central Bank (ECB) issued *Note: Comprehensive Assessment, October 2013*. The note explains the ECB's plan to carry out, during 2014, a comprehensive assessment of the eurozone banking system before assuming its new supervisory tasks in November 2014. The assessment is to cover the most significant 130 banks in the eurozone, and will be based on three pillars, as follows.

| | |
|---|---|
| 1 **Supervisory risk assessment** | • Supervisory judgments on key risk factors, such as liquidity, leverage and funding.<br>• Quantitative and qualitative analysis. |
| 2 **Asset quality review** | • Assessment of data quality, asset valuations, classifications of non-performing exposures, collateral valuation and provisions.<br>• Covering credit and market exposures, following a risk-based, targeted approach. |
| 3 **Stress test** | • Forward-looking view of banks' shock-absorption capacity under stress.<br>• Conducted in collaboration with the European Banking Authority. |

The European Banking Authority (EBA) has also asked national supervisors in other countries in the European Economic Area to carry out asset quality reviews that will feed into stress tests on other major banks outside the eurozone.

## What are the accounting implications?

The note states that the ECB's assessment will be broad and will comprise credit and market exposures, including a review of hard-to-value illiquid assets, which in the absence of a liquid market or close comparators, need to be valued using models. The specific objectives of the asset quality review will be:

- assessment of adequate provisioning for credit exposures;
- determination of the appropriate valuation of collateral for credit exposures; and
- assessment of the valuation of complex instruments and high-risk assets.

The note states that all types of financial instruments will be subject to revision according to a 'conservative interpretation' of current IFRS, where necessary taking national GAAP into account, and that the review will be conducted with reference to harmonised definitions, including those of 'forbearance' and 'non-performing exposures' proposed recently by the EBA[2].

The phrase "revision according to a conservative interpretation of current IFRS" is not explained.

The IASB's *Conceptual Framework for Financial Reporting* states that the fundamental qualitative characteristics of useful financial information include faithful representation– i.e. financial information should be neutral and free from bias. However, the judgements exercised by banks' management in respect of impairment and valuation will probably be subject to additional scrutiny and challenge for regulatory purposes.

Stress tests will be conducted in collaboration with the EBA, which will also cover any countries that the ECB programme does not cover. Full details of how the stress test will be conducted

2 Final draft *Implementing Technical Standards On Supervisory Reporting* on forbearance and non-performing exposures under article 99(4) of Regulation (EU) No. 575/2013.

have not been published but the ECB has announced a capital benchmark of 8 percent Common Equity Tier 1. The ECB's review could potentially have far-reaching consequences for some banks. Bank managements will have to consider the possible outcome of supervisory stress tests when assessing a bank's ability to continue as a going concern and whether there are any material uncertainties that should be disclosed under IFRS. The upcoming stress tests may also impact disclosures about how a bank manages its capital.

IFRS does not define the terms 'forbearance' and 'non-performing loans'. However, banks increasingly use such terminology for the purposes of disclosures, encouraged by regulators and users – e.g. see the European Securities and Markets Authority's report *Treatment of Forbearance Practices in IFRS Financial Statements of Financial Institutions*[3]. The EBA has proposed definitions for regulatory purposes, which include the following.

| Term | EBA definition |
|---|---|
| **Forbearance** | Forborne exposures are debt contracts in respect of which forbearance measures have been extended. 'Forbearance measures' consist of concessions granted to a debtor facing, or about to face, difficulties in meeting its financial commitments. 'Concession' refers to either of the following actions:<br>• a modification of the previous terms and conditions of a contract that would not have been granted had the debtor not been in financial difficulties; or<br>• a total or partial refinancing of a troubled debt contract, that would not have been granted had the debtor not been in financial difficulties. |
| **Non-performing exposures** | Exposures that satisfy either or both of the following criteria:<br>• material exposures that are more than 90 days past due; and/or<br>• the debtor is assessed as unlikely to pay its credit obligations in full without realisation of collateral, regardless of the existence of any past-due amount or of the number of days past due. |

Banks may want to bear these definitions in mind when preparing the disclosures in their annual financial statements.

## Next steps

Over the coming months, the methodology and data requirements for the ECB assessment will be further developed and the ECB will provide further information to the participating banks. In particular, greater detail on the stress-testing methodology would assist banks in assessing the possible impact on them. The assessment is likely to require a major investment of time and effort by banks to assemble the data required by reviewers. Also, any need to raise additional capital, or reduce exposures, would represent a major commercial issue for affected banks.

3 The European Securities and Markets Authority (ESMA), ESMA/2012/853 *Treatment of Forbearance Practices in IFRS Financial Statements of Financial Institutions*, issued on 20 December 2012.

## ESMA announces financial statement enforcement priorities for 2013

On 11 November 2013, ESMA published its European common enforcement priorities for 2013 financial statements. These priorities are to be used by European Economic Area national authorities in their assessment of listed companies' 2013 financial statements.

Two of ESMA'S focus areas are likely to be of particular interest to banks:

- fair value measurement and disclosure; and
- measurement of financial instruments and disclosure of related risks.

Other focus areas are: impairment of non-financial assets, measurement and disclosure of post-employment benefit obligations, and disclosures related to significant accounting policies, judgements and estimates. ESMA and the national competent authorities will monitor the application of the IFRS requirements outlined in these priorities. ESMA expects to publish its findings in early 2015.

## ESMA finds room for improvement in banks' disclosures

Following the financial crises, the transparency and comparability of the financial statements of financial institutions have gained increased importance for users. To help address this demand, ESMA published on 18 November 2013 a review of the comparability and quality of disclosures in the 2012 financial statements of 39 major European financial institutions.

ESMA believes that the quality and comparability of the IFRS financial statements of banks could be enhanced in the following areas:

- the structure and content of the income statement;
- liquidity and funding risk, including asset encumbrance;
- hedging and the use of derivatives;
- credit risk, with a focus on credit quality, forbearance practices, non-performing loans and concentrations of risk; and
- the criteria used to assess the impairment of equity securities that are classified as available-for-sale.

Some of the conclusions are consistent with the report issued in August 2013 by the FSB's[4] Enhanced Disclosures Task Force (EDTF) on implementation of its recommendations – see the Q3 2013 issue of *The Bank Statement*.

ESMA expects financial institutions and their auditors to consider the findings of this review when preparing and auditing 2013 IFRS financial statements.

As with ESMA's recently announced enforcement priorities for 2013, we expect that regulatory bodies within and outside Europe will take notice of this report and pay particular attention to these areas of focus for financial institutions.

## BCBS review of trading book

On 31 October 2013, the Basel Committee on Banking Supervision (BCBS) issued a second consultative paper, *Fundamental review of the trading book: A revised market risk framework*. The paper discusses the following areas:

- the trading book/banking book boundary;
- the treatment of credit;
- the approach to risk measurement;
- a comprehensive incorporation of the risk market liquidity;
- the treatment of hedging and diversification;

4 FSB – Financial Stability Board.

- the relationship between internal models and standardised approaches;
- a revised models-based approach; and
- a revised standardised approach.

The proposals may result in a significant increase in disclosure requirements.

The proposals may interact with accounting and disclosure requirements relating to financial instruments. For example, the proposals would introduce a more precise definition of the trading book. The definition would include both:

- a description of the purpose for which financial instruments are held; and
- a presumption that certain types of instruments would be included in or excluded from the trading book.

Most listed equities and certain equity investments in funds would be part of the trading book. But unlisted equities would not. Banks would need to understand the difference between the accounting and regulatory requirements to be clear why the numbers reported for each purpose would be different.

Other proposed changes may impact the requirement under paragraph 34 of IFRS 7 to provide summary quantitative data about exposure to risk, based on the information provided internally to key management personnel. For example, a move away from value at risk may impact disclosures of market risk, including sensitivity analysis.

Comments on the proposals are due by 31 January 2014.

## IVSC issues an exposure draft on credit and debit valuation adjustments

On 3 December 2013, the International Valuation Standards Council (IVSC) issued exposure draft (ED) *Credit and Debit Valuation Adjustments*. The ED was prepared by a working group formed in 2012 by the IVSC Standards Board to examine inconsistencies in reflecting non-performance risk in the valuation of financial instruments and to identify general accepted approaches and principles for making appropriate adjustments.

The ED proposes guidance on the following:

- the principles of credit valuation adjustment (CVA) and debit valuation adjustment (DVA);
- techniques and inputs for making adjustments;
- key challenges in calculating CVA and DVA and suggestions for generally accepted practices to address them;
- the consideration of DVA and its links with the cost of funding; and
- practical implications for financial reporting (IFRS and US GAAP) and the Basel III regulatory requirements.

Comments on the ED are due by 28 February 2014.

# YOU MAY ALSO BE INTERESTED TO READ …

### IFRS Newsletter: Financial Instruments – Issues 16, 17 and 18


Highlights the recent discussions and tentative decisions of the IASB on the financial instruments project.

October, November and December 2013

### IFRS Newsletter: Revenue – Issue 11


Outlines the current thinking on the revenue project, and what the proposals could mean for entities.

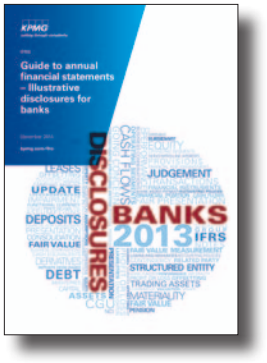
October 2013

### First Impressions: IFRS 9 (2013) – Hedge accounting and transition


Considers the requirements of the new general hedge accounting model in IFRS 9 *Financial Instruments* (2013).

December 2013

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




Takes account of the impact of new or revised IFRSs, which are effective for the first time for an annual reporting period ending on 31 December 2013.

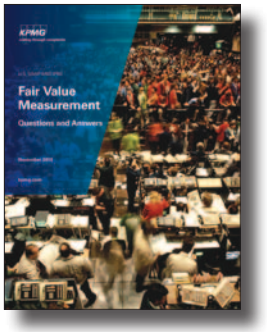
December 2013

### In the Headlines: IFRS: New standards – Issue 2013/22


A summary of newly effective and forthcoming standards. This edition covers financial years ending on or after 31 December 2013, including interim periods within those financial years.

December 2013

### Fair Value Measurement – Questions and Answers – November 2013




Focuses on fair value measurement, providing guidance on the application of the standards and highlighting the handful of differences between US GAAP and IFRS.

November 2013

### In the Headlines: Focus areas for regulators – Issue 2013/17


Considers the 2013 enforcement priorities issued by ESMA, highlighting the areas of focus for European national regulators when reviewing IFRS financial statements for the year ending 31 December 2013.

November 2013

### In the Headlines: Improving the quality of disclosures – Issue 2013/18


Considers the implications for financial institutions and beyond of ESMA's intention to focus on monitoring the level of impairment of financial assets and improving the level of transparency in the areas of forbearance, liquidity risk, asset encumbrance and fair value measurement.

November 2013

Click on the images above to access the publications.

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## Acknowledgements


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

KPMG International Standards Group is part of KPMG IFRG Limited.

Publication name: *The Bank Statement*

Publication number: Issue 12

Publication date: January 2014



**kpmg.com/ifrs**

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

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