

The Bank Statement

IFRS – Global Banking Newsletter

“The two impairment models are conceptually similar in that they are both ‘expected’ rather than ‘incurred’ loss models. However, the measurement objectives, details of the calculation and the scope of the requirements differ.”

- **Ewa Bialkowska**
KPMG in the UK
- **Mahesh Narayanasami**
KPMG in the US

Comparing IFRS 9 and US GAAP impairment

Welcome to the Q3 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 IASB released a webcast dealing with incorporating forward-looking information on measuring expected credit losses (ECL) – see [page 2](#).

Impairment: IFRS 9 vs US GAAP

We compare and contrast the new US GAAP impairment model and the IFRS 9 impairment requirements – see [page 5](#).

Regulation in action: European Banking Authority consults on credit risk and accounting for ECL

The article discusses the EBA's draft guidelines on credit institutions' credit risk management practices and accounting for ECL – see [page 15](#).

How do you compare? Disclosures on the impact of Brexit

We look at the interim reports of 13 European banks reporting under IFRS to compare their disclosures about the impact of the UK's vote to leave the EU – see [page 17](#).

Spotlight on IFRS 9

The IASB released a webcast on incorporating forward-looking information when measuring ECL.

IASB webcast on incorporating forward-looking information in measuring ECL

In July 2016, the IASB released a webcast discussing incorporating forward-looking information and multiple scenarios when measuring expected credit losses (ECL) under IFRS 9 *Financial Instruments*. The webcast covers items such as:

- when multiple scenarios are relevant and the concept of non-linearity;
- consistency of scenarios;
- probability-weighted assessment of a significant increase in credit risk; and
- approaches to incorporating forward-looking scenarios.

The webcast is available on the [IASB's website](#).

EBA consults on credit risk and accounting for ECL

In July 2016, the European Banking Authority (EBA) issued a consultation paper seeking stakeholder feedback on its draft guidelines on credit institutions' credit risk management practices and accounting for ECL. See [page 15](#).

Impact of IFRS 9 on insurers: Applying IFRS 9 with IFRS 4

In September 2016, the IASB issued amendments to IFRS 4 *Insurance Contracts*. The amendments provide two optional solutions to reduce the impact of the differing effective dates between IFRS 9 (i.e. 1 January 2018) and the forthcoming insurance contracts standard.

Option 1: temporary exemption from IFRS 9	Rather than having to implement IFRS 9 in 2018, some companies will be permitted to continue to apply IAS 39 <i>Financial Instruments: Recognition and Measurement</i> . To qualify, a reporting company's activities need to be predominantly connected with insurance.
Option 2: overlay approach	This solution provides an overlay approach to presentation to alleviate temporary accounting mismatches and volatility. For designated financial assets, a company is permitted to reclassify between profit or loss and other comprehensive income (OCI) the difference between the amounts recognised in profit or loss under IFRS 9 and those that would have been reported under IAS 39.

IASB activities affecting your bank

The IASB instructed the staff to explore whether there is a more effective way of clarifying which standards apply to long-term interests.

IFRS 9 and IAS 28: Measurement of long-term interest

In May 2016, the IFRS Interpretations Committee tentatively decided to develop a draft interpretation that will address the accounting for long-term interests in an associate or a joint venture that, in substance, forms part of the net investment in that associate or joint venture, but to which the equity method is not applied (long-term interests).

The Committee tentatively decided to include the following in the draft interpretation:

- a. a requirement to allocate impairment losses recognised on the net investment in an associate or a joint venture between the investment accounted for using the equity method and long-term interests, in the reverse order of seniority;
- b. a requirement to provide disclosures about long-term interests that meet the overall objective in IFRS 12 *Disclosure of Interests in Other Entities*;
- c. an example illustrating the application of the proposals to long-term interests;
- d. retrospective application of the proposals with permission not to restate comparative information, unless the entity chooses to restate comparative information on initial application of IFRS 9;
- e. transition requirements equivalent to those described in (d) above for entities applying the temporary exemption from IFRS 9;
- f. a requirement for first-time adopters whose first IFRS reporting period begins before 1 January 2019 to apply the proposals retrospectively, but be permitted not to restate comparative information, unless they choose to restate comparative information relating to IFRS 9 on initial adoption of IFRS; and
- g. an effective date of 1 January 2018.

At its September 2016 meeting, the IASB agreed with the Committee's technical conclusions, but expressed concern about certain aspects of the draft interpretation. As a result, the IASB objected to the release of the draft interpretation and instructed the staff to explore whether there is a more effective way of clarifying which standards apply to long-term interests.

IFRS 9: Fees and costs included in the 10 percent test for the derecognition of liabilities

In September 2016, the IFRS Interpretations Committee reconfirmed its tentative technical conclusion reached in May 2016 on the fees and costs to be included in the '10 percent test' for the purpose of determining whether a modified financial liability should be derecognised under IAS 39 and IFRS 9.

In the tentative agenda decision, the Committee noted that when applying paragraphs AG62 of IAS 39 and B3.3.6 of IFRS 9 the 10 percent test includes only fees paid or received between the entity and the lender and fees paid or received by either the entity or the lender on the other's behalf.

However, the Committee agreed that further discussion was necessary before concluding on whether to recommend to the IASB that an amendment be made to IFRS 9 and IAS 39 as part of an annual improvement or whether to issue an agenda decision.

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

The IFRS Interpretations Committee received a request to clarify the requirements in IFRS 9 on modifications or exchanges of financial liabilities. More specifically, the request asked whether an entity recognises a gain or loss in profit or loss when a financial liability is modified or exchanged and that modification or exchange does not result in derecognition of the financial liability.

During its September 2016 meeting, the Committee decided to postpone discussions on this issue to a future meeting.

Financial instruments with characteristics of equity

In July and September 2016, the IASB continued its discussions on financial instruments with characteristics of equity.

In July, the discussions focused on how to apply the Gamma approach¹ to: the classification of derivatives on own equity; asset/equity exchange derivatives; and liability/equity exchange derivatives. In September, the IASB discussed derivatives on own equity under the Gamma approach, focusing on the presentation of specific types of derivatives classified as liabilities and how disclosures could complement approaches to classification and presentation.

The next steps for the project will be to consider:

- classification of instruments meeting the existing puttables exception;
- accounting for conditional alternative settlement outcomes; and
- recognition/derecognition and reclassification of equity instruments.

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

1. See *IFRS Newsletter: Financial Instruments*, [September 2015](#).

Impairment: IFRS 9 vs US GAAP

“What is clear is that the two sets of requirements are quite different. This is likely to prove a challenge for dual reporters. The impact of different effective dates for both new standards will also have to be managed.”

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Over the next few years, entities that report under IFRS or US GAAP (or both) will adopt new requirements on the accounting for credit losses. The two impairment models are conceptually similar in that they are both ‘expected’ rather than ‘incurred’ loss models. However, the measurement objectives, details of the calculation and the scope of the requirements differ. This article compares and contrasts a few key aspects of the two models.

A quick recap

In June 2016, the FASB issued Accounting Standards Update (ASU) 2016-13, *Financial Instruments – Credit Losses (Topic 326)*, which introduced an expected credit loss model (the CECL model). The Update’s effective date is 1 January 2020 (calendar year) for public business entities that are Securities and Exchange Commission (SEC) filers². Entities can early adopt the new standard in fiscal years beginning after 15 December 2018. The Update does not contain changes to any other aspect of the accounting for financial instruments, such as classification, measurement or hedge accounting.

The IASB’s IFRS 9 was published in July 2014, with an effective date of 1 January 2018 and early adoption permitted. It also introduced an ECL model for measuring impairment of financial instruments, and a common theme is that both impairment models have a more forward-looking perspective and accelerate recognition of losses. However, IFRS 9 has also changed other aspects of the accounting for financial instruments, such as classification and measurement, which interact with the scope of the impairment requirements. In contrast, the US GAAP requirements on classification and measurement remain largely unchanged, with ASU 2016-01 introducing only minor modifications.

The introduction of the new impairment requirements represents the IASB’s and FASB’s response to the financial crisis of 2008–2009 and concerns about ‘too little, too late’ provisioning. The requirements of the currently effective standards under both IFRS and US GAAP are based on an incurred credit loss model that, in the view of many stakeholders, results in the delayed recognition of credit losses.

2. For all other entities, the standard is effective for fiscal years beginning after 15 December 2020.

Scope: What's in and what's not

The following table highlights the financial instruments in the scope of each impairment model.

IFRS 9	US GAAP
<ul style="list-style-type: none"> – Financial assets that are debt instruments measured at amortised cost or fair value through other comprehensive income (FVOCI); these include loans, trade receivables and debt securities – Loan commitments issued that are not measured at fair value through profit or loss (FVTPL) – Financial guarantee contracts issued that are in the scope of IFRS 9 and are not measured at FVTPL – Lease receivables in the scope of IAS 17/IFRS 16 <i>Leases</i> – Contract assets in the scope of IFRS 15 <i>Revenue from Contracts with Customers</i> 	<ul style="list-style-type: none"> – Loans, trade receivables and debt securities classified as held-to-maturity – Loan commitments that are not measured at fair value through net income – Financial guarantee contracts that are not accounted for as insurance contracts or at fair value through net income – A lessor's net investment in a sales-type or a direct financing lease – Reinsurance receivables – Contract assets in the scope of Topic 606 <i>Revenue from Contracts with Customers</i>

As can be seen from the table, there are a number of scope similarities, but there are also some key differences. For example, debt instruments measured at FVOCI are subject to the IFRS 9 ECL impairment requirements, whereas under US GAAP debt securities classified as available-for-sale are not in the scope of the CECL model. Instead, the FASB made some targeted amendments to the 'other-than-temporary-impairment' (OTTI) model for available-for-sale debt securities, whereby recognition of credit losses would be required only when the fair value is less than the amortised cost.

Under IFRS 9, equity securities (whether they are measured at FVTPL or at FVOCI) are excluded from impairment requirements. In contrast, under the changes introduced in ASU 2016-01 in US GAAP, certain equity securities are subject to impairment³.

Expected loss concept behind both models

Both impairment models are based on the expected loss concept. However, the mechanics by which expected losses are measured diverge.

3. Equity securities without a readily determinable fair value that are not eligible for the net asset value practical expedient may be measured using the measurement alternative, which is cost less impairment plus/minus changes in observable prices for the same or a similar security.

IFRS 9

The general approach under IFRS 9 requires the recognition of either 12-month ECL or lifetime ECL if there has been a significant increase in credit risk since initial recognition of a particular instrument. These are defined as follows.

12-month ECL	The portion of lifetime ECL that results from default events that are possible within 12 months after the reporting date
Lifetime ECL	The ECL that result from all possible default events over the expected life of a financial instrument

Accordingly, the general IFRS 9 ECL model is a relative one and the amount of ECL recognised depends on whether there has been a significant increase in credit risk since initial recognition. This is illustrated in the following diagram.



IFRS 9 does not define what is meant by 'significant'. Banks will have to apply judgement to define 'significant' in the context of their specific products. This is one of the key judgemental areas of the IFRS 9 impairment model.

A simplified approach is available for trade and lease receivable and contract assets. Also, as a simplification, entities may assume that the criteria to recognise lifetime ECL have not been met if an instrument has low credit risk at the reporting date. This simplification may provide some relief from tracking the changes in credit risk of instruments that are considered to be of high credit quality. However, if the instrument no longer has low credit risk, then the general impairment requirements apply – i.e. it cannot be assumed that, in this circumstance, lifetime ECL should be recognised. This means that entities taking advantage of this simplification would need to have data available to enable an assessment of whether credit risk has increased significantly, should the instrument no longer have low credit risk. In addition, some regulators⁴ do not support the use of this practical expedient for loans held by certain banks.

US GAAP

In contrast, the CECL model applies a single measurement objective – lifetime ECL – that is estimated for all financial instruments in scope, regardless of their credit risk at the reporting date as compared with initial recognition. This is a significant difference between the two models from both a technical and an operational perspective. In our experience, a large proportion of the implementation efforts of IFRS 9 focuses on the requirements to determine whether the credit risk of a financial instrument has increased significantly since its initial recognition.

4. Basel Committee on Banking Supervision, [Guidance on credit risk and accounting for credit losses](#), issued in December 2015.

The nuts and bolts: Measuring ECL

The table below summarises some of the other differences between the two models.

	IFRS 9	US GAAP
Definition of ECL	The weighted average of credit losses with the respective risks of a default occurring as the weights. <i>[IFRS 9 Appendix A]</i>	No explicit definition. However, the Update specifies that the allowance is a valuation account that is deducted from the amortised cost basis of the financial asset(s) to present the net amount expected to be collected on the financial asset(s). <i>[326-20-30-1]</i>
Probability-weighted estimate of ECL	The estimate of ECL should be an unbiased and probability-weighted amount, which entails evaluating a range of possible outcomes, rather than basing it on a best or worst-case scenario. There is no requirement for every possible scenario to be identified, but the ECL estimate should at least reflect the probability of a credit loss occurring and the probability of no credit loss occurring. <i>[IFRS 9.B5.5.41–B5.5.42]</i>	There is no explicit requirement for ECL estimates to reflect multiple, probability-weighted outcomes. For example, a single best estimate economic forecast may be used. <i>[BC 50–52]</i>
Zero ECL	There is no practical expedient to recognise zero ECL.	In limited circumstances, an ECL measurement is not required when historical information, adjusted for current conditions and reasonable and supportable forecasts, results in an expectation that the risk of non-payment of the amortised cost basis of an instrument is zero. <i>[326-20-30-10]</i>
Time value of money	The measurement of ECL should reflect the time value of money whereby the ECL amount is discounted to the reporting date (not the expected default date). The discount rate is generally the current effective interest rate (EIR) or an approximation. <i>[IFRS 9.B5.5.44]</i>	Entities can follow either a discounted cash flow method or other methods such as loss rates, roll rates etc. <i>[326-20-30-3]</i> If a discounted cash flow method is used, the EIR is used to discount expected cash flows. <i>[326-20-30-4]</i>

	IFRS 9	US GAAP
Measurement on an individual or collective basis	<p>There is no general guidance on when ECL should be measured on an individual or collective basis.</p> <p>However, if an entity does not have reasonable and supportable information that is available without undue cost or effort to measure lifetime ECL on an individual basis, then ECL are recognised on a collective basis.</p> <p>Assets are grouped on the basis of shared credit risk characteristics – e.g. instrument type, credit risk ratings, collateral type, date of initial recognition and geographic location of the borrower. <i>[IFRS 9.B5.5.4–B5.5.5]</i></p>	<p>Entities are required to measure ECL on a collective (pool) basis when financial assets have similar risk characteristics, which include asset type, internal or external credit score or credit ratings, collateral type, term, geographic location etc.</p> <p>When a financial asset does not share similar risk characteristics with other financial assets, entities measure ECL on an individual basis.</p> <p><i>[326-20-30-2; 55-5]</i></p>
Troubled debt restructurings (TDR)	<p>There is no TDR concept under IFRS. If the contractual terms of a financial asset are restructured then an assessment has to be made as to whether the asset should be derecognised and a new asset based on the restructured terms recognised.</p> <p>If a new asset is recognised then a new EIR is calculated and the loss allowance is initially measured at 12-month ECL or lifetime ECL if it is credit-impaired at initial recognition.</p>	<p>The concept of TDR remains under the CECL model. Assets meeting the definition of TDR are treated as a continuation of the original instrument rather than the creation of a new one. Consequently, EIR is not recalculated.</p> <p>A restructuring of a debt constitutes a TDR if a creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider.</p> <p><i>[310-40-35-10]</i></p>

Forward-looking information: What should be considered?

IFRS 9

One of the main areas of challenge when implementing the IFRS 9 impairment model is consideration of forward-looking information⁵ for both assessing whether credit risk on a financial asset has increased significantly and measuring ECL. As IFRS 9 requires the use of 'reasonable and supportable information that is available without undue cost or effort', information from a variety of sources should normally be considered.

IFRS 9 does not require a detailed estimate for periods that are far in the future, and for such periods allows extrapolation of projections from available detailed information. It also acknowledges that, in some cases, the best reasonable and supportable information could be the unadjusted historical information, depending on the nature of the historical information and when it was calculated, compared with the circumstances at the reporting date and the characteristics of the financial instrument considered.

Incorporation of forward-looking information into the measurement of ECL was discussed by the Impairment Transition Group (ITG) and included in the guidance issued by the Global Public Policy Committee (GPPC)⁶. In particular, it was discussed when more than one forward-looking scenario had to be incorporated into the measurement of ECL, and how many economic scenarios to consider.

Topics discussed	Summary of discussion
When non-linear relationships exist between different forward-looking scenarios and their associated credit losses	More than one forward-looking scenario needs to be incorporated into the measurement of ECL. The manner of incorporation of the scenarios has to reflect the non-linear impacts.
Number of economic scenarios to consider	IFRS 9 does not prescribe the number of scenarios to be used. However, it requires the measurement to be 'unbiased'. This could be achieved by modelling a base, upside and downside scenarios. The scenarios have to be representative and capture material non-linearities.

US GAAP

The use of forward-looking information for the measurement of ECL is also mandatory for the CECL model. However, for future periods for which reasonable and supportable forecasts are not available, entities revert to historical loss information.

Although both IFRS and US GAAP require the use of reasonable and supportable information which is available without undue cost or effort, US GAAP requires entities to revert to historical loss information for periods for which reasonable and supportable forecasts are not available.

Also, under the CECL model a single best estimate economic forecast may be used.

5. See also *The Bank Statement*, [Q1 2016](#).

6. Available [online](#).

Purchased credit-impaired (PCI) or purchased credit-deteriorated (PCD) assets

Under both IFRS 9 and US GAAP, special rules exist for purchased assets that are credit-impaired (IFRS) or have experienced a more-than-insignificant credit deterioration (US GAAP). The definitions of these categories differ between IFRS and US GAAP and so differences in application will probably arise in practice.

Further, under IFRS these requirements apply to both originated and purchased assets whereas under US GAAP they apply only to purchased assets, although this will probably not result in material differences in practice as originated credit-impaired assets are rare. The table below summarises the key differences between the two approaches.

	IFRS 9	US GAAP
Definition of PCI/PCD	A purchased financial asset for which one or more credit events have occurred that have a detrimental effect on the estimated future cash flows of the asset. <i>[IFRS 9 Appendix A]</i>	<p>Loans</p> <p>Purchased individual assets (or groups of assets with similar risk characteristics) that have experienced, at acquisition, a more-than-insignificant deterioration in credit quality since origination. <i>[Topic 326-20 glossary]</i></p> <p>Available-for-sale debt securities</p> <p>The indicators of credit loss should be met. <i>[326-30-30-2]</i></p> <p>Beneficial interests</p> <p>They are PCD assets if either the criterion applicable to loans is met or there is a significant difference between contractual cash flows and expected cash flows at the date of initial recognition. <i>[325-40-30-1A]</i></p>

	IFRS 9	US GAAP
Measurement on initial recognition	Credit-adjusted EIR is calculated on initial recognition and incorporates ECL as of that date. The ECL included in the credit-adjusted EIR are not included in the loss allowance. <i>[IFRS 9.5.5.13]</i>	A loss allowance is recognised for lifetime ECL with a corresponding adjustment to the amortised cost basis of the PCD asset. As a result of this 'gross-up' adjustment, the loss allowance estimated at the time of the initial recognition of the asset is not included in earnings. <i>[326-20; 326-30]</i> If a discounted cash flow method is used to measure ECL, then the EIR is the rate that equates the present value of the expected cash flows on the asset with the purchase price. If a method other than the discounted cash flow method is used, then the EIR is the rate that equates the present value of the contractual cash flows on the asset with its amortised cost basis. <i>[326-20-30-14; 326-30-30-3]</i>
Subsequent measurement	ECL are measured at an amount equal to changes in lifetime ECL from initial recognition. Any positive changes to future expected cash flows are recognised as an impairment gain even if they exceed the losses expected on initial recognition of the asset. <i>[IFRS 9.5.5.14]</i>	All subsequent changes in lifetime ECL are recognised in earnings and increase or reduce the loss allowance recognised on initial recognition. <i>[326-20-35-1; 326-30-35-12]</i>

Judgement will be required to assess if an asset is credit-impaired (IFRS) or if it has a more-than-insignificant deterioration in credit quality since origination (US GAAP). IFRS 9 provides guidance on when an asset is credit-impaired but no similar guidance is available under US GAAP.

For PCD assets, there is no immediate effect on earnings at acquisition because of the 'gross up' approach under US GAAP (or inclusion of the initial ECL in the EIR under IFRS). In contrast, non-PCD assets will generally result in recognising a loss in earnings at the first reporting date after acquisition despite the absence of credit deterioration.

Credit cards

IFRS 9

IFRS 9 includes specific requirements for financial instruments that include both a loan and an undrawn commitment component and the entity's contractual ability to demand repayment and cancel the undrawn commitment does not limit the entity's exposure to credit losses to the contractual notice period. (See paragraph 5.5.20 in IFRS 9.)

An example of such an instrument is a credit card. For such, and only such, instruments, an entity measures ECL over the period for which it is exposed to credit risk and ECL would not be mitigated by credit risk management actions, even if that period extends beyond the maximum contractual period.

This requirement has proved very difficult to implement in practice for instruments such as credit cards and has resulted in many discussions, including deliberations by the ITG. The issues discussed include the following.

- How should credit risk management actions be incorporated into estimating the maximum period of exposure?
- What are the events leading to derecognition of a credit card?
- Is the drawn and undrawn balance a single unit of account?

US GAAP

The estimation of credit losses for undrawn loan commitments is for the contractual period over which an entity is exposed to credit risk via a present contractual obligation to extend credit. If the obligation is unconditionally cancellable by the issuer (which is often the case for credit cards), then the entity does not recognise any credit losses. The drawn balance attracts the ECL in the usual way. Exclusion of the undrawn portion of credit cards from the ECL model when the issuer has an unconditional right to cancel the obligation represents a significant simplification in comparison with the IFRS requirements.

Interest recognition

IFRS 9

Under IFRS 9, the manner in which interest revenue is recognised depends on whether an asset is credit impaired and, if so, whether it has become credit-impaired after initial recognition or it was credit-impaired on initial recognition.

The following table summarises the approach.

Nature of the asset	Interest recognition under IFRS
Not credit-impaired on initial recognition or subsequently	EIR is applied to the gross carrying amount
Not credit-impaired on initial recognition but impaired subsequently	EIR is applied to the amortised cost ⁷ of the asset after the asset becomes credit impaired.
Credit-impaired on initial recognition	Credit-adjusted EIR is applied to the amortised cost of the asset

US GAAP

Interest is generally recognised by applying the EIR on the amortised cost basis of a financial asset. The amortised cost basis does not include the allowance for credit losses except for those assets that are considered credit-deteriorated at acquisition for which the initial allowance is included in the amortised cost basis.

In practice, banks follow non-accrual policies based on regulatory requirements when:

- payment in full of principal or interest is not expected; or
- principal or interest is 90 days past due unless the asset is both well secured and in the process of collection.

Still work in progress

The differences highlighted in this article are based on our initial reading of the Update. As IFRS 9 was issued some time ago, many banks reporting under the IFRS framework are well advanced with incorporating its requirements and market practice is emerging. This process is just beginning for the new US GAAP requirements.

However, what is clear is that the two sets of requirements are quite different. This is likely to prove a challenge for dual reporters. The impact of different effective dates for both new standards will also have to be managed.

With time, further areas of complexity or different interpretations may emerge. Full understanding of the differences between the two set of rules is still a work in progress.

7. 'Amortised cost' is defined as the amount at which a financial asset or financial liability is measured on initial recognition minus the principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount and, for financial assets, adjusted for any loss allowance.

Regulation in action: EBA consults on credit risk and accounting for ECL

The proposed guidelines would affect all credit institutions in the EU, regardless of size or complexity.

In July 2016, the EBA issued a consultation paper seeking stakeholder feedback on its draft guidelines on credit institutions' credit risk management practices and accounting for ECL⁸.

The proposals have been drafted in response to guidance on the same topic issued by the Basel Committee on Banking Supervision in December 2015⁹. The proposed guidelines aim to ensure sound credit risk management practices associated with the implementation and ongoing application of the accounting for ECL.

Scope

The proposed guidelines will apply to all credit institutions in the EU. They are designed to be aligned with the Basel Committee guidance, which was drafted largely with a focus on internationally active banks. Although the Basel Committee guidance does not elaborate further on what constitutes an internationally active bank, it is generally understood to refer to systemically large credit institutions.

The EU had 5,906 credit institutions as at 31 December 2014 and the proposed guidelines would apply to all of them. Out of this total number, 156 or 3 percent represented 75 percent of the total assets of all credit institutions in the EU¹⁰. Although the proposed guidelines state that they would apply to smaller credit institutions proportionately (see below) a question nevertheless arises whether additional guidelines (over and above IFRS 9) should apply to the remaining 97 percent, given that they represent only 25 percent of total assets, and instead whether the scope of the proposed guidelines should align with the Basel Committee guidance.

Proportionality

As the proposed guidelines would apply to all EU credit institutions, they state that the requirements should be applied proportionately: credit institutions should comply with the requirements in a manner that is appropriate to their size and internal organisation and the nature, scope and complexity of their activities. It is likely to be a challenge for credit institutions to make such an assessment of proportionality.

Generally, proportionality is a concept more relevant to supervisors of credit institutions for the purpose of determining how they design and enforce regulations. It is less clear how the concept should be applied by credit institutions themselves. The challenge is even greater here because of the limited information in the proposed guidelines on *how* credit institutions should operationalise the proportionality concept.

The proposed guidelines would also permit smaller, less complex credit institutions to place more reliance on the practical expedients available under IFRS 9. Judgement would be required when assessing the size of a credit institution for the purpose of determining whether greater reliance can be placed on the practical expedients available under IFRS 9. Without any size thresholds specified, this assessment may vary across credit institutions, resulting in inconsistent application of the proposed guidelines.

8. Available on the EBA's [website](#).

9. *Guidance on credit risk and accounting for expected credit losses*, available on the Basel Committee's [website](#).

10. Page 57 of the proposed guidelines.

Alignment with the Basel Committee guidance

In the remaining areas, the proposed guidelines are broadly aligned with the Basel Committee guidance and largely achieve its stated objective, but there are some differences. Therefore, it cannot be assumed that knowing and understanding the requirements of the Basel Committee guidance translates into a full and thorough understanding of the proposed guidelines.

The proposed guidelines use different terminologies in some sections and include a few additional references and proposals that are not in the Basel Committee guidance and are specific to EU law. For example, when considering indicators of a significant increase in credit risk, the proposed guidelines would require credit institutions to take into account expectations of modifications due to financial difficulties, including those qualifying as forbearance in accordance with EU Regulation 2015/22. In this regard, challenges may arise around interpreting what modifications qualify as forbearance from a legal perspective.

Impact assessment

The proposed guidelines include an impact assessment whereby the overall costs and benefits of introducing them are assessed against a baseline scenario.

The baseline scenario states that not introducing the proposed guidelines may result in the low-quality implementation of applicable accounting requirements and create an un-level playing field on an international level when the Basel Committee guidance is implemented internationally. However, this is only true for entities in the scope of the Basel Committee guidance, which is aimed at systemically large credit institutions, not smaller credit institutions.

Date of implementation

The proposed implementation date of 1 January 2018 is aligned with the effective date of IFRS 9.

Next steps

The closing date for submission of comments to the EBA is 26 October 2016.

The proposed guidelines would affect all credit institutions in the EU, regardless of size or complexity. Typically, it is larger credit institutions that respond to EBA consultations. However, in this instance those larger credit institutions will already be focusing on complying with the full Basel Committee guidance. We encourage all affected credit institutions to carefully consider the appropriateness of the proposals in relation to the nature of their operations and respond to the consultation on the EBA [website](#).

How do you compare? Disclosures on the impact of Brexit

Perhaps unsurprisingly, the most extensive and specific disclosures were provided by banking groups located in the UK.

In June 2016, the UK voted to leave the EU. This decision may have an impact on many European entities – and, potentially, entities based in other countries. We have looked at 13 large European banks' 30 June 2016 interim reports to compare their disclosures about the impact of Brexit.

What are the disclosure requirements?

All of the banks in our sample prepared their interim reports in accordance with the requirements of IAS 34 *Interim Financial Reporting*. This standard requires entities to include in their interim financial reports an explanation of events and transactions that are significant to an understanding of the changes in the financial position and performance of the entity since the previous annual reporting date. Information presented should update the relevant information presented in the most recent annual financial report.

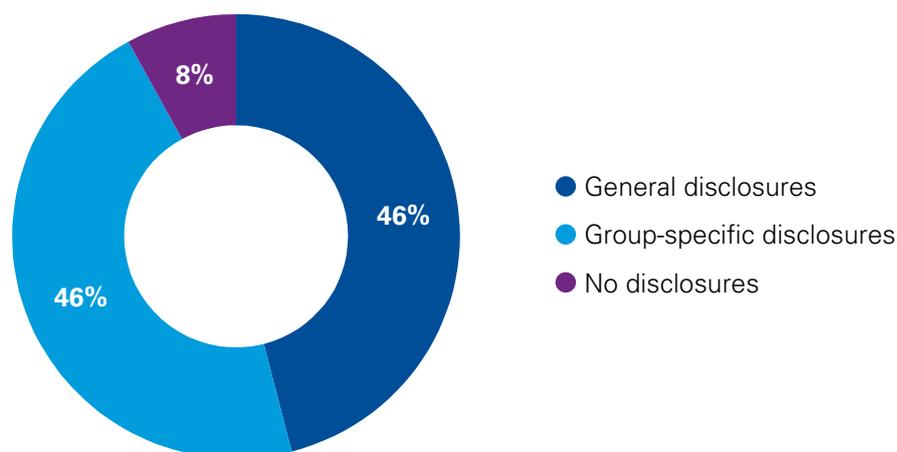
Some of the disclosure requirements relating to annual financial statements that could be relevant include:

- IAS 1 *Presentation of Financial Statements*: disclosure of estimation uncertainties, assumptions about the future and other judgements relevant to assets and liabilities in the financial statements and information about managing capital; and
- IFRS 7 *Financial Instruments: Disclosures*: disclosure of the nature and extent of risks arising from financial instruments and how the entity manages those risks.

What did banks disclose?

Most of the banks in our sample provided some disclosures relating to the UK referendum result, although the details varied. This is illustrated in the following chart.

Banks providing disclosures on the impact of the UK referendum



Perhaps unsurprisingly, the most extensive and specific disclosures were provided by banking groups located in the UK. The disclosures provided were mostly qualitative in nature, with a few banks also providing quantitative disclosures. A variety of information was provided, with some common themes being: potential future impacts, activities undertaken to manage Brexit risks, and financial impacts.

Potential future impacts

Most banks mentioned that the UK referendum result created considerable uncertainty and its full impact will only be known as the detailed negotiations between the UK and EU and its other trading partners progress.

Examples of potential future impacts discussed included:

- the types of exposures that are likely to be most affected by Brexit;
- the impact on the business model;
- risk to the bank's ability to provide cross-border services;
- the impact on the legal framework within which the bank operates;
- an impact on credit rating; and
- more detailed descriptions of the impact on credit, market and operational risks.

Activities undertaken to manage Brexit risks

A number of banks disclosed the activities that they have undertaken to manage the impact of Brexit. These included:

- carrying out funding activities before the UK referendum to ensure that there was sufficient liquidity across different lines of business. These banks disclosed that such liquidity planning resulted in an increase in liquid assets – particularly cash and cash equivalents;
- performing scenario analysis and stress testing to identify areas of potential weakness in the event of a vote to leave the EU, as well as formulating possible mitigating actions;
- undertaking risk assessments, including evaluating the potential for contagion;
- creating a Brexit executive committee and working groups;
- assessing the impact on the current business model;
- assessing the resilience of IT infrastructure in anticipation of higher volumes of transactions; and
- assessing redenomination risk as a result of a country leaving the eurozone.

Financial impact

Banks provided a mixture of qualitative and quantitative information on the financial statement impact. This included:

- the foreign exchange impact of the weakening of sterling, with one bank quantifying the foreign exchange gain that arose as a result of the weakening of sterling;
- a decrease in leverage ratios;
- a reduction in Tier 1 capital, due largely to adverse movements in foreign exchange rates;
- an increase in risk-weighted assets, mainly due to market movements following the UK referendum result and collateral inflows; and
- a comment from one bank that it had not seen any material asset quality deterioration following the Brexit decision, and one from another mentioning an additional valuation reserve created.

Where regulation and reporting meet...

ESMA issues the 19th extract from its confidential database of enforcement decisions on financial statements.

ESMA publishes extracts from its database of enforcement decisions

On 27 July 2016, the European Securities and Markets Authority (ESMA) issued the 19th extract from its confidential database of enforcement decisions on financial statements¹¹. The aim of the publication is to strengthen supervisory convergence and provide issuers and users of financial statements with relevant information on the appropriate application of IFRS.

The decisions included in this extract were taken by national enforcers in the period from February 2014 to April 2016. ESMA expects to publish the next extract later in 2016.

The document describes 12 enforcement decisions, four of which are particularly relevant for banks:

- inflation-related index derivative embedded in a host lease contract;
- selecting the appropriate exchange rate when multiple exchange rates are available;
- identifying unobservable inputs; and
- accounting for contributions to a deposit guarantee fund in the interim financial report.

Inflation-related index derivative embedded in a host lease contract

Fact pattern

The entity has entered into several multi-year operating leases of buildings in the eurozone, with rental payments denominated in euro. Under the contract, the increase in rent during the first eight years is determined by multiplying the change in the harmonised index of consumer prices (HICP) by a factor of 1.85. From Year 9 until the end of the lease term, the increase in rent will be determined by multiplying the HICP by a factor of 1.5.

The issuer determined that the inflation-related derivative is an embedded derivative but it does not need to be separated because it is closely related. In particular, the issuer concluded that the feature is not leveraged by analogising to paragraph AG33(a) of IAS 39 (i.e. the 'double-double' test).

Enforcer's decision

The enforcer disagreed with the issuer's accounting treatment and determined that the embedded derivative had to be separated from the host lease contract because the contract contained leverage. The enforcer noted that leverage generally occurs when there is a multiplier above one that has more than an insignificant effect.

The enforcer noted that the conclusion in each example in paragraph AG33 of IAS 39 is specific to the facts and circumstances described and is subject to different requirements, so analogous application of the conclusion from one sub-paragraph to a different situation addressed by another sub-paragraph is not appropriate.

11. Available on [ESMA's website](#).

Selecting the appropriate exchange rate when multiple exchange rates are available

Fact pattern

The issuer undertakes operations in a number of countries, including Venezuela. The Venezuelan bolivar fuerte (VEF) is subject to strict currency restrictions and is not freely exchangeable. Venezuelan currency exchange legislation was amended in the first quarter of 2015, with the result that as at 30 June 2015 the following three official rates of exchange of VEF to US dollars existed:

- the variable SICAD rate, which was USD 1 = VEF 12.8;
- the newly created SIMADI rate, which allowed individuals and businesses to buy and sell foreign currency more easily and to offset the parallel market rate. This was USD 1 = VEF 197; and
- the existing ‘official rate’ (CENCOEX) available to certain sectors considered to be a priority, which was fixed at USD 1 = VEF 6.3.

The issuer changed the rate at which it consolidated its Venezuelan operations from the SICAD rate to the SIMADI rate during H1 2015. The issuer was of the view that the SIMADI rate was the rate at which it would extract economic benefit and was therefore most appropriate to use. The issuer provided disclosures in its half-yearly report relating to the change in rate.

Enforcer’s decision

The enforcer agreed with the issuer’s accounting treatment and disclosures on the basis of paragraph 26 of IAS 21 *The Effects of Changes in Foreign Exchange Rates*, which states that when several exchange rates are available, the rate used is that at which the future cash flows represented by the transaction or balance could have been settled if those cash flows had occurred at the measurement date.

The enforcer noted that paragraph 26 of IAS 21 requires the exercise of judgement, and did not disagree with the issuer’s assertion that the SIMADI rate is the most appropriate rate because the issuer believed this is the rate at which it extracts economic benefit.

Identifying unobservable inputs

Fact pattern

The issuer, a real estate investment trust (REIT), disclosed that the capitalisation rate and stabilised net rental income (SNRI) were the key unobservable inputs/assumptions used for determining the fair value of investment properties. The enforcer noted that for the capitalisation rate, the issuer disclosed all of the information required by paragraph 93 of IFRS 13 *Fair Value Measurement* but for SNRI, the issuer’s fair value notes did not disclose:

- a description of the valuation technique and the inputs used in the fair value measurement of the investment property;
- quantitative information about the significant unobservable inputs used in the fair value measurement of investment property; and
- a narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs if a change in those inputs to a different amount might result in a significantly higher or lower fair value measurement.

The issuer argued that the disclosures required by paragraph 93 of IFRS 13 were not provided for the SNRI because it was not a significant unobservable input (this contradicted the issuer's disclosure of what input it considers significant).

Enforcer's decision

The enforcer did not agree with the issuer and concluded that SNRI was a significant unobservable input used for the valuation technique and that all relevant disclosures should have been provided.

Accounting for contributions to a deposit guarantee fund in the interim financial report

Fact pattern

The issuer is a credit institution that is subject to a deposit guarantee scheme under local legislation. The issuer is required to make non-refundable cash contributions to the deposit scheme at an amount calculated as a percentage of the deposits held at the end of the year, irrespective of the amount of deposits held at other times of the year.

The issuer's accounting policy was to recognise in each interim period a provision for these contributions proportional to the estimated amount to be paid within two months of the end of the year. At the interim reporting date, the issuer recognised a provision equal to 50 percent of the expected total annual levy for the year.

Enforcer's decision

The enforcer disagreed with the issuer's accounting treatment and concluded that no provision should have been recognised for the contributions to the deposit guarantee fund at the interim reporting date. This is because the obligating event – i.e. the bank holding deposits at the end of the annual reporting period – had not yet occurred.

The enforcer noted that under paragraph 13 of IFRIC 21 *Levies*, in the interim financial report, an entity does not recognise a liability to pay a levy if there is no present obligation to pay it at the end of the interim reporting period.

ECB launches public consultation on guidance to banks on non-performing loans

On 12 September 2016, the ECB launched a public consultation on guidance to banks on non-performing loans (NPL)¹². The proposed guidance is addressed to all significant institutions supervised directly by the ECB.

The proposed guidance addresses the aspects of strategy, governance and operations, which the ECB regards as key to successfully resolving NPL. It provides recommendations to banks and sets out a number of best practices that will constitute the ECB's supervisory expectations going forward.

The proposed guidance includes proposals for NPL recognition and NPL impairment measurement. It acknowledges that it cannot provide specific accounting requirements, but rather describes best practices on provisioning principles and methodology for NPLs that may be applied within existing accounting frameworks.

12. [ECB draft guidance to banks on non-perform loans](#).

For example, it proposes that banks should:

- ensure that regulatory and accounting definitions align whenever possible;
- use the EBA's *Implementing Technical Standards* supervisory reporting requirements for NPL and forbearance as supported by ESMA for public disclosures;
- reconcile any deviations between exposure classification in accounting and regulatory view (conceptual and quantitative);
- disclose assumptions underlying the definition of impaired financial assets (including materiality thresholds or methods used for past-due counting), in addition to disclosures required by IFRS 7;
- define criteria for exposures requiring individual assessment of provisions;
- follow a conservative approach for the estimation of future cash flows and collateral;
- use a sophisticated approach to impairment allowances for financial guarantee contracts and loan commitments; and
- keep a sufficient level of documentation detailing provisioning methodology and parameters.

The consultation period runs until 15 November 2016, with a public hearing scheduled for 7 November 2016.

You may also be interested to read...

Insights into IFRS: 13th Edition 2016/17



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

September 2016

IFRS Newsletter: Financial Instruments – Issues 31 and 32



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

July and September 2016

First Impressions: Amendments to IFRS 4



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

September 2016

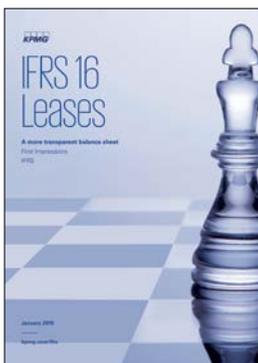
IFRS Newsletter: IFRS 9 Impairment – Issue 3



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

December 2015

First Impressions: IFRS 16 Leases



Explains the key requirements, highlights areas that may result in a change in practice, and features KPMG insights.

January 2016

IFRS Newsletter: Insurance – Issues 54 and 55



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

May and June 2016

Click on the images above to access the publications.

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