

The Bank Statement

IFRS – Global Banking Newsletter

“Many banks started their IFRS 9 implementation projects by focusing on specific accounting issues known to be challenging, and did not focus sufficiently on the broader impact of adopting the standard.”

– **Gerd Straub and Gudrun Hartig**,
Accounting Advisory Services,
KPMG in Germany

IFRS 9 implementation and Pillar 3

Welcome to the Q4 2015 issue of our quarterly banking newsletter in which we provide updates on IFRS developments that directly impact banks and consider the potential accounting implications of regulatory requirements.

Spotlight on IFRS 9

The IFRS Transition Resource Group for Impairment of Financial Instruments holds its last scheduled meeting on implementing the impairment requirements of IFRS 9 *Financial Instruments* – see [page 2](#).

IASB activities affecting your bank

The IASB publishes IFRS 16 *Leases*. The standard is effective for accounting periods beginning on or after 1 January 2019 – see [page 5](#).

Implementing the classification and measurement requirements of IFRS 9

Implementing the classification and measurement requirements of IFRS 9 brings with it its own complexities, but also defines the scope of the impairment part of the project.

In our experience, many banks have underestimated the effort needed to perform the analysis of whether contractual cash flows from financial assets represent solely payments of principal and interest on the principal amount outstanding.

We look at some of the practical issues arising in the field – see [page 9](#).

Regulation in action – Pillar 3

Disclosures required under Pillar 3 of the *Basel Framework* cover much common ground with the requirements of IFRS 7 *Financial Instruments: Disclosures*. With the implementation of IFRS 9 and the revised requirements under Pillar 3, both sets of rules are changing.

We discuss the issues and likely next steps. – see [page 13](#).

Spotlight on IFRS 9

The ITG will stand ready in case any subsequent issues for discussion emerge.

ITG holds its last scheduled meeting on implementing impairment requirements

At its third substantive meeting – in December 2015 – the IFRS Transition Resource Group for Impairment of Financial Instruments (the ITG) discussed the following issues submitted by stakeholders.

1. Incorporation of forward-looking scenarios.
2. Scope of paragraph 5.5.20 of IFRS 9 *Financial Instruments*.
3. Measurement of expected credit losses (ECLs) for charge cards.
4. Period over which to measure ECLs for revolving credit facilities.
5. Collateral and other credit enhancements and the measurement of ECLs.
6. Inclusion of cash flows expected from the sale of a defaulted loan in the measurement of ECLs.
7. Meaning of current effective interest rate.
8. Assessment for significant increases in credit risk for financial assets with a maturity of less than 12 months.
9. Measurement of the loss allowance for credit-impaired financial assets.
10. Presentation of the loss allowance for financial assets measured at amortised cost.

Some of the main points on which ITG members appeared to agree were as follows.

- The objective of IFRS 9 is to achieve an unbiased and probability-weighted estimate of ECLs. Therefore, when incorporating forward-looking scenarios, an entity should consider the range and probabilities of different outcomes (Issue 1).
- The chair emphasised that the exception in paragraph 5.5.20 of IFRS 9 was meant for a narrow set of circumstances. It is relevant where there is an inter-relationship between the drawn and undrawn amounts that are not distinguished for risk management purposes (Issue 2).
- A charge card agreement might include no commitment to extend further credit (Issue 3).
- When determining the period over which an entity is expected to be exposed to credit risk (when applying paragraph 5.5.20), an entity should consider the credit risk management actions that management expects to carry out and that serve to mitigate ECLs (Issue 4).
- An entity may include cash flows expected from the sale of a defaulted loan in measuring ECLs (Issue 6).

Next steps

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

Currently, no further physical ITG meetings are scheduled. However, the chair indicated that the ITG will continue to exist, and should stand ready in case any subsequent issues for discussion emerge. The chair said that stakeholders could continue to submit questions, and that a decision would then be taken on next steps. One potential outcome would be the publication of educational material.

For more information see our *IFRS 9 Impairment Newsletter*, [December 2015](#).

Basel Committee guidance on credit risk and accounting for ECLs

In response to the recent global shift towards using ECL accounting models, on 18 December 2015 the Basel Committee on Banking Supervision issued [Guidance on credit risk and accounting for expected credit losses](#). The guidance sets out supervisory requirements on sound credit risk practices associated with the implementation and ongoing application of ECL accounting models and replaces the previous guidance issued in June 2006.

It contains 11 fundamental principles for credit risk and accounting for ECLs. It also includes guidance specific to banks applying IFRS, and relating to the new ECL model in IFRS 9, in particular on:

- the loss allowance equal to 12-month ECLs;
 - the assessment of significant increases in credit risk; and
 - the use of practical expedients.
-

EDTF guidance on new credit risk disclosures

In November 2015, the Financial Stability Board's Enhanced Disclosure Task Force (EDTF) issued its report [Impact of expected credit loss approaches on bank risk disclosures](#). The report considers disclosures that may be useful to help the market understand the reporting changes resulting from the new accounting ECL models. It builds on the principles first outlined in 2012¹.

The updated report covers:

- *temporary considerations*: these are disclosures made before, and on, transition to the ECL model; and
- *permanent considerations*: these are ongoing disclosures following implementation of the ECL model.

For pre-transition disclosures, the EDTF recommends an approach that weighs the timing of quantitative and qualitative information against the reliability of that information, such that the nature and extent of disclosures will develop gradually in the run-up to a 2018 implementation date.

For more information, see [our analysis](#) online.

1. [Principles and Recommendations for Enhancing the Risk Disclosures of Banks](#).

Impact of IFRS 9 on insurers

In December 2015, the IASB published exposure draft ED/2015/11, *Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts*. The exposure draft responds to significant concerns raised by the insurance industry about the differing effective dates of IFRS 9 (1 January 2018) and the forthcoming standard on accounting for insurance contracts (not before 2020). It proposes two potential solutions.

1. Temporary exemption from applying IFRS 9

- Some entities would be permitted to defer the effective date of IFRS 9.
- Insurance activities would have to be an entity's predominant activity.
- The temporary exemption would apply at the reporting entity level.

2. Overlay approach

- For specified financial assets, the difference between the profit or loss figures under IFRS 9 and the previous standard could be recognised in other comprehensive income (OCI).
- Eligible financial assets would relate to contracts that:
 - are in the scope of IFRS 4;
 - are classified at fair value through profit or loss (FVTPL) in their entirety under IFRS 9; and
 - were not classified at FVTPL in their entirety under IAS 39 *Financial Instruments: Recognition and Measurement*.

The IASB asked for comments on its proposals by 8 February 2016.

For more information, see our [New on the Horizon: Amendments to IFRS 4](#).

IASB activities affecting your bank

The IASB discussions focused on the classification of derivatives on own equity.

Financial instruments with characteristics of equity

In October 2015, the IASB continued discussing its research project on financial instruments with characteristics of equity, focusing on the classification of derivatives on own equity. The agenda paper for the meeting outlined the challenges and summarised how IAS 32 *Financial Instruments: Presentation* deals with them. The IASB directed the staff to:

- consider how the existing requirements for classifying derivatives on own equity in IAS 32 would fit with the approaches identified in the September 2015 IASB meeting; and
- identify potential areas in which the existing requirements might be improved.

The classification of specific types of instruments such as contingent convertible bonds (CoCos) and put options written on non-controlling interests (NCI puts) will be discussed at a future meeting.

The Board did not make any decisions during this meeting.

For more information, see our *IFRS Newsletter: Financial Instruments*, [October 2015](#).

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

In November 2015, the IASB discussed the findings of its research on the measurement proposals included in the exposure draft *Measuring Quoted Investments in Subsidiaries, Joint Ventures and Associates at Fair Value* issued in September 2014 (the ED).

The discussion focused on the assessment of the population of entities that would be affected by the ED's proposals, and the feedback received from valuation specialists, accounting firms, securities regulators, the Accounting Standards Advisory Forum and the staff of the US FASB.

The Board did not make any decisions during this meeting.

Deferral of effective date for accounting for transactions between investors and associates or joint ventures

On 17 December 2015, the IASB announced that it has postponed the date on which entities have to change some aspects of how they account for transactions between investors and associates or joint ventures. The postponement applies to changes introduced in September 2014 through narrow-scope amendments to IFRS 10 *Consolidated Financial Statements* and IAS 28 *Investments in Associates and Joint Ventures*. These changes affect how an entity should determine any gain or loss that it recognises when assets are sold or contributed between the entity and an associate or joint venture in which it invests and do not affect other aspects of how entities account for their investments in associates and joint ventures.

This removes the current requirement to make these particular changes by 2016.

The Board explained that this decision has been made because it is planning a broader review that may result in the simplification of the accounting for such transactions and of other aspects of accounting for associates and joint ventures.

The IFRIC Interpretations Committee acknowledged that the question on derecognition of modified financial assets would require an amendment to the standard.

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

In November 2015, the IFRS Interpretations Committee continued its discussions relating to the interaction between IFRS 9 and IAS 28 with respect to the measurement of long-term interests that in substance form part of the net investment in the associate or joint venture. Previously, the Committee had noted that there were divergent views on how to account for the impairment of such interests, and that the interaction between the requirements of IFRS 9 and IAS 28 in relation to this issue was unclear. Accordingly, the Committee considered that an amendment to the standard would be required to clarify the requirements.

In November 2015, the Committee discussed measurement alternatives, but did not reach a consensus. The Committee noted that the scope exception in IFRS 9 is not clear on the key issue of whether the long-term interests are subject to the IFRS 9 impairment requirements. The Committee decided to consult the IASB about whether and how the scope exception in IFRS 9 should apply to such long-term interests in associates and joint ventures.

Derecognition of modified financial assets

In November 2015, the IFRS Interpretations Committee discussed a potential narrow-scope project to clarify the guidance in IFRS 9 and IAS 39 about when a modification or exchange of financial assets results in the derecognition of the original asset.

Although a number of Committee members acknowledged that this is an issue that arises in practice, they considered that given the broad nature of the issue it could not be resolved through an interpretation and instead would require an amendment to the standards. Consequently, the Committee tentatively decided not to progress it at this time.

IFRS 9 – Determining hedge effectiveness for net investment hedges

In November 2015, the IFRS Interpretations Committee discussed whether the ‘lower of’ test that is required to measure the ineffectiveness of cash flow hedges should also be applied for net investment hedges.

The Committee observed that:

- paragraph 6.5.13 of IFRS 9 requires hedges of a net investment in a foreign operation to be accounted for similarly to cash flow hedges, which indicates that the ‘lower of’ test should also be applied; and
- the application of the ‘lower of’ test avoids the recycling of exchange differences arising from the hedged items that have been recognised in other comprehensive income before the foreign operation being disposed of, and that this outcome is consistent with the requirements of IAS 21 *The Effects of Changes in Foreign Exchange Rates*.

Determination of what constitutes an intention to settle on a net basis would depend on the details of each cash-pooling arrangement.

In addition, the Committee noted that:

- there appears to be no evidence of significant diversity in practice by entities reporting under IAS 39; and
- because so few entities have adopted the hedging requirements in IFRS 9, it is too early to assess whether the issue is widespread among entities reporting under IFRS 9. However, the Committee did not expect significant diversity to arise when IFRS 9 is adopted more widely.

Accordingly, the Committee determined that neither an interpretation nor an amendment to a standard was necessary, and therefore tentatively decided not to add this issue to its agenda.

Offsetting and cash-pooling

In November 2015, the IFRS Interpretations Committee discussed whether certain cash-pooling arrangements would meet the requirements for offsetting under IAS 32.

In the cash-pooling arrangement under discussion, each subsidiary within a group had a legally separate bank account. Both the bank and the group had the legally enforceable right to set off balances in these bank accounts, as required by paragraph 42(a) of IAS 32. Interest was calculated on a notional basis using the net balance of all accounts.

The group also had a practice of regular physical transfers of balances on individual accounts into a single netting account. However, these transfers were not required under the terms of the arrangement and were not performed at the reporting date. The specific question asked was whether the practice of these regular transfers of balances (but not at the reporting date) into a netting account would be sufficient to demonstrate an intention to settle the entire period-end account balances on a net basis as required by paragraph 42(b) of IAS 32.

The Committee noted that the entity should consider the requirements of paragraphs 46 and 47 of IAS 32 to assess whether, at the reporting date, there is an intention to settle individual account balances on a net basis or whether the intention is for various entities within the group to use those individual account balances for other purposes before the next net settlement date.

In the example presented, before the next net settlement date the period-end balances may change as group entities place further cash on deposit or withdraw cash to settle other obligations. Such expected future activity before the next net settlement date means that the entity does not expect to settle the period-end balances on a net basis. Accordingly, the Committee noted that it would not be appropriate for the entity to assert that it had the intention to settle the entire period-end balances on a net basis. This is because presenting these balances net would not appropriately reflect the amounts and timings of the expected future cash flows, taking into account the entity's normal business practice.

However, the Committee also observed that in other cash-pooling arrangements, an entity may not expect the period-end balances to change before the next net settlement date and, consequently, it noted that an entity would be required to apply its judgement in determining whether there was an intention to settle on a net basis in those circumstances.

The Committee also noted that many different cash-pooling arrangements exist in practice and so the determination of what constitutes an intention to settle on a net basis would depend on the individual facts and circumstances of each case. In the light of this and given the existing IFRS requirements, the Committee considered that neither an amendment to IAS 32 nor an interpretation was necessary, and consequently tentatively decided not to add the issue to its agenda.

Insurance contracts project

In October 2015, the IASB discussed:

- addressing the consequences of the differing effective dates of IFRS 9 and the new insurance standard;
- the classification and measurement of financial assets on transition;
- the mirroring approach; and
- the presentation and disclosure assessment.

In November 2015, the Board considered discretionary cash flows and evaluated the differences between the general measurement model and the variable fee approach.

The IASB has now completed most of its deliberations, including evaluating the differences between the general measurement model and the variable fee approach for direct participating contracts. It will continue discussing the treatment of discretion in participating contracts under the general measurement model and the due process steps at an upcoming meeting.

The effective date will be discussed when the publication date is more certain.

For more information, see our *IFRS Newsletter: Insurance*, [October](#) and [November 2015](#).

Leases final standard

IFRS 16 *Leases* was published on 13 January 2016. The standard is effective for accounting periods beginning on or after 1 January 2019. Early adoption is permitted, provided that the company has adopted IFRS 15 *Revenue from Contracts with Customers*.

For our high-level summary and in-depth analysis, see [our website](#).

Classification and measurement under IFRS 9 – Insights from the field

“In our experience, many of the issues relating to the business model assessment arise in portfolios classified as available-for-sale.”

– **Gerd Straub and Gudrun Hartig**,
Accounting Advisory Services,
KPMG in Germany

The implementation of IFRS 9 continues to dominate our conversations with clients. In our [Q2 2015 Bank Statement](#), we discussed some of the complexities of the contractual cash flows analysis. In this article, we share more lessons that we have learned while helping our clients with their projects implementing IFRS 9, primarily in the German market.

Recap on classification of financial assets under IFRS 9

Under IFRS 9, the classification and measurement of financial assets depends on the contractual cash flow characteristics of an asset and on the business model within which the asset is held, as follows².

Measurement basis	Cash flow characteristics	Objective of the business model within which the asset is held	Do the impairment requirements of IFRS 9 apply?
Amortised cost	Contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding (SPPI criterion)	To hold the financial asset in order to collect contractual cash flows – i.e. held to collect (HTC model)	Yes
Fair value through other comprehensive income (FVOCI)	Contractual cash flows comply with the SPPI criterion	Achieved by both: collecting contractual cash flows and selling the financial asset (HTC and sell model)	Yes
Fair value through profit or loss (FVTPL)	Financial assets whose cash flows do not comply with the SPPI criterion (irrespective of the business model within which they are held) or financial assets that are not held in the business models above (irrespective of whether their contractual cash flows comply with the SPPI criterion)		No

2. This ignores an option to designate certain financial assets at FVTPL and an equity investment at FVOCI.

Implementing IFRS 9 – Our experience in the German market

Most banks are in the advanced stages of completing the conceptual analysis of adopting IFRS 9 and starting work on design and IT implementation.

Many had started with the impairment requirements, and postponed the phase dealing with classification and measurement. However, they have now realised that there is an important interaction between the two phases and that determining the appropriate classification under IFRS 9 is not as straightforward as they may have initially expected.

Many banks started with specific accounting issues known to be challenging, and did not focus sufficiently on the broader impact of adopting the standard – e.g. product development, incentive and compensation systems, risk and regulatory requirements and KPIs, and internal process design.

'Principal' is defined as the fair value of the financial instrument on initial recognition. 'Interest' is defined as the time value of money, the credit risk associated with the principal amount outstanding during a particular period of time and for other basic lending risks and costs, as well as profit margin³.

In our experience, the implementation issues arising from the classification and measurement requirements of IFRS 9 relate to interpretation of the standard. However, there are also process and IT challenges that often determine the final implementation decisions.

Business model assessment

The term 'business model' refers to the way a bank manages its financial assets in order to generate cash flows. IFRS 9 requires the assessment to be determined at a level that reflects the way groups of financial assets are managed together to achieve a particular business objective. The business model does not depend on management's intentions for an individual financial instrument. Accordingly, this condition is not an instrument-by-instrument approach to classification, but should be determined at a higher level.

Banks generally make the assessment of a business model at a portfolio level.

In our experience, many of the issues relating to the business model assessment arise in portfolios classified as available-for-sale under IAS 39. Available-for-sale financial assets are most frequently held in 'HTC and sell' business models. However, these portfolios often include financial assets that do not meet the SPPI criterion and consequently have to be classified as at FVTPL under IFRS 9.

Financial assets classified as loans and receivables under IAS 39 (and consequently measured at amortised cost under IAS 39) are often held in a business model that is HTC under IFRS 9, and those classified as held to maturity are always held in this business model. However, it is not uncommon for some aspects of the contractual terms of these assets to fail the SPPI criterion. Again, these assets have to be measured at FVTPL under IFRS 9.

IFRS 9 does not change the definition or measurement for assets classified as 'trading'. However, if a business model for assets classified as trading under IAS 39 has changed so that at the date of initial application of IFRS 9 they are held in either HTC or HTC and sell business models, then further analysis will be required to determine their classification under IFRS 9.

What happens if an asset in a HTC portfolio does not meet the SPPI criterion?

Banks may find that an HTC portfolio (let's call it Portfolio P) includes certain financial assets that do not meet the SPPI criterion. Under IFRS 9, these assets do not have to be excluded from Portfolio P but do have to be measured at FVTPL. This can present an operational challenge. From a practical perspective, banks may place these financial assets in a sub-portfolio within Portfolio P so that they are subject to a separate, ongoing valuation and monitoring process. This approach would result in Portfolio P being subject to two ongoing measurement processes, potentially using two different IT systems. This is likely to have an impact on costs and governance, because those in charge of the portfolio will have to be familiar with both amortised cost and fair value measurement basis. For these reasons, in our experience this is not a solution generally preferred by banks.

3. Paragraph 4.1.3 of IFRS 9.

Many banks have underestimated the effort needed for the SPPI analysis.

Another approach may be to change the way such assets are managed and transfer them to a separate portfolio that is managed on a fair value basis. The portfolio could then be moved to an appropriate IT platform and be integrated in internal processes for assets measured at FVTPL.

The advantage of this approach is that it provides an efficient process for dealing with assets that have to be handled differently. In addition, it improves transparency for the assets and enables separate monitoring. For these reasons, in our experience this is the solution most frequently adopted by banks.

However, this approach has its own challenges. In some cases, a transfer of assets creates a negative effect on the strategy of the original portfolio (Portfolio P in our example). If a certain type of loan is completely removed from the portfolio, then the way the remaining portfolio is managed is likely to be affected. In particular, its risk management and hedging arrangements will often have to be changed.

There may well be other impacts concerning transferred assets – e.g. removing them from the portfolio might have an impact on the portfolio manager's compensation. In addition, it might be difficult to find a manager for a portfolio that is composed of 'SPPI test-failing assets' without creating a specific strategy for the portfolio.

If failed-SPPI assets are transferred to a separate FVTPL grouping, solely for IT valuation purposes, but are still managed together with amortised cost assets in the original portfolios, then the grouping created for the IT valuation purposes will not form a separate portfolio from an IFRS 9 perspective. However, if the assets are no longer managed as part of the original portfolio, then it will have to be determined which business model the assets are held in.

SPPI criterion

In our experience, many banks undertaking IFRS 9 implementation projects have underestimated the effort needed to perform the SPPI analysis. For many, the SPPI analysis has proved to be a very time-consuming activity. However, in most cases time can be saved by following a well-defined structured approach that aims to minimise the number of contracts whose detailed contractual terms have to be examined.

Where banks use highly standardised contract agreements, time can be saved by clustering such contracts and performing a detailed review on a selection that reflects the contractual terms in a cluster. Some banks start their SPPI assessment by defining materiality levels and tailoring the SPPI analysis accordingly.

In many cases, the time required to analyse the contractual terms of financial assets can be additionally reduced by using an appropriate analysis tool, and we have seen such tools work in an efficient way.

A number of tools are available. For example, KPMG has developed a Lending Tool with a structured decision tree that we have used on a number of engagements. In addition to creating a structured analysis process, this tool adds transparency and creates structured documentation of the analysis undertaken and conclusions reached.

Determining the measurement bases of financial assets affects the scope of the impairment part of the project.

What to analyse first: Classification and measurement or impairment requirements of IFRS 9?

Some banks started their implementation projects by looking first at the impairment requirements. This was because they expected the most significant impact from the adoption of IFRS 9 to result from the new expected credit loss model introduced by the standard.

However, this approach disregards the strong interdependency between classification and measurement and the impairment requirements of IFRS 9. It is the classification and measurement part of the standard that will determine the population of items that will be subject to its impairment requirements. Under IFRS 9, only financial assets measured at amortised cost and FVOCI are subject to the impairment requirements. The impairment requirements do not apply to financial assets that are held in an HTC business model but fail the SPPI criterion and are therefore measured at FVTPL. Accordingly, the determination of the measurement basis of financial assets under IFRS 9 cannot be left until the impairment part of the project has been completed.

In practice, both phases of IFRS 9 implementation – i.e. classification and measurement, and impairment – will have to be run in parallel. However, a preliminary assessment of any changes to the measurement basis of financial assets will have to be made first to understand what portfolios and types of instruments will be subject to the impairment requirements of IFRS 9. Also, information on the contractual terms of instruments, such as no-recourse or contractually-linked features, will help to inform the design of impairment models and the scope of the impairment part of the project.

Implementation projects are gathering pace

As IFRS 9 implementation projects are gathering pace, more issues are likely to emerge. For now, we would like to emphasise the importance of the classification and measurement part of the projects.

Regulation in action – Pillar 3 is changing

The revised Pillar 3 disclosures focus on linkages between financial statements and regulatory exposures, credit risk, counterparty credit risk, securitisation and market risk.

Richard Andrews, Financial Services, KPMG in the UK

We have explored before⁴ the interaction between Pillar 3 of the *Basel Framework*⁵ and the disclosure requirements of IFRS 7 *Financial Instruments: Disclosures*. We now return to this topic, because both the accounting and the regulatory requirements in this area are changing.

Changes to Pillar 3

Pillar 3 of the *Basel Framework* complements the minimum capital requirements (Pillar 1) and the supervisory review process (Pillar 2) by seeking to enhance market discipline through minimum regulatory disclosure requirements.

Following its introduction in 2004, the Pillar 3 landscape remained relatively stable until 2015. After the global financial crisis, it became apparent that the existing Pillar 3 framework failed to promote the identification of a bank's material risks and its capital adequacy, and did not allow for adequate comparison between banks. To address these issues, the Basel Committee embarked on a Pillar 3 framework review. In January 2015, the Basel Committee issued revised Pillar 3 disclosure requirements resulting from the first phase of its review.

The revised Basel Committee Pillar 3 disclosures focus on disclosures of linkages between financial statements and regulatory exposures, credit risk, counterparty credit risk, securitisation and market risk. The revised requirements introduce 40 templates (of which 20 are in a fixed format), and aim to improve the comparability and consistency of disclosure across banks.

The revised disclosures will put additional pressure on banks as more granular prescribed disclosures (e.g. credit risk disclosures split by product type and counterparty credit risk disclosures by prescribed probability of default bands) will need to be prepared at a higher frequency (four templates quarterly and 22 semi-annually) and in shorter timelines (concurrently with financial reporting) by teams that are already heavily involved in other regulatory and accounting initiatives.

It is expected that EU law makers and regulators will make a significant effort in 2016 to implement these revised disclosure requirements for the EU banks. In addition, in its work programme for 2016 the European Banking Authority (EBA) announced that it will focus on improving banks' own disclosures within and beyond Pillar 3 (e.g. asset quality and internal models), and that one of its main outputs will be guidelines on implementing the Basel Committee's revised Pillar 3 disclosures in the EU.

The Basel Committee announced that it will publish subsequent phases of its Pillar 3 framework review in the coming years. These are expected to include ongoing efforts to consolidate existing disclosure requirements (i.e. interest rate risk in the banking book and operational risk) and the introduction of new disclosures (e.g. on the total loss absorbing capacity and the hypothetical standardised approach to credit risk) into a comprehensive and coherent Pillar 3 framework.

4. The Bank Statement, [Q3 2014](#).

5. [Basel Committee: Revised Pillar 3 disclosure requirements](#).

Regulators are increasingly focusing on the comparability of these risk disclosures between Pillar 3, financial statements and other public disclosures.

Interaction with IFRS and other disclosures

Both Pillar 3 and IFRS require a bank to disclose information about the nature and extent of the risks arising from its financial instruments. This includes a description of how those risks are managed and quantitative information on exposure to those risks. One of the key principles in the Basel Committee's revised January 2015 Pillar 3 disclosures is that, where they are meaningful, linkages must be provided to line items in the bank's balance sheet and/or the statement of profit or loss and OCI.

Regulators are increasingly focusing on the comparability of these risk disclosures between Pillar 3, financial statements and other public disclosures – e.g. the EDTF⁶.

IFRS 9 introduced consequential amendments to IFRS 7 that include expanded disclosure on credit risk management practices, quantitative and qualitative information about amounts arising from expected credit losses and more extensive information on credit exposures. Future changes to Pillar 3 reporting are likely to include the latest round of regulation (which many commentators have termed Basel IV) and the requirements of IFRS 9.

The Basel Committee intends to maintain an ongoing relationship with the accounting standard setters, given that their continuing work may have implications for the disclosures required in Pillar 3.

The coming together of a continuously evolving and increasing regulatory landscape, the upcoming implementation of IFRS 9, and the increased demands from regulators for enhanced, comparable and reliable risk disclosures mean only one thing for Pillar 3 – more scrutiny and focus on more granular, more standardised and more frequent Pillar 3 reporting on existing and new risk disclosures.

6. [The Enhanced Disclosure Task Force](#) issued its first report in 2012.

Where regulation and reporting meet...

The proposals may impact implementation of the ECL impairment model.

Definition of default – EBA consults on new guidelines and clarifications

On 22 September 2015, the EBA issued a consultation paper (EBA/CP/2015/15) *Guidance on the application of the definition of default under Article 178 of Regulation (EU) 575/2013*. The paper proposes clarifications to the application of the definition of default for the purpose of calculating regulatory capital. It has been issued with the aim of increasing comparability, because the EBA has in the past identified different practices applied by regulated institutions, which were a driver behind the variability of risk estimates and capital requirements.

The proposed clarifications include the following aspects:

- days past due criterion;
- unlikelihood to pay;
- conditions for the return to non-default status;
- treatment of the definition of default in external data;
- application of the default definition in a banking group; and
- certain specific matters relating to retail exposures.

The EBA noted that implementation of the proposals may have a significant impact on some institutions, in particular those that use the IRB approach to calculate capital. Accordingly, it proposes to implement the guidance after a phase-in period.

Possible interactions with IFRS 9

The proposals may impact banks' implementation of the ECL impairment model of IFRS 9. The standard does not define the term 'default' (although it contains certain minimum requirements), but instead requires each entity to do so. Entities can use a regulatory definition, as long as it is consistent with their credit risk management practices and considers qualitative indicators⁷.

The guidance⁸ on implementing the IFRS 9 expected credit loss model for banks issued by the Basel Committee recommends that in defining default for accounting purposes banks are guided by the definition used for regulatory purposes. Accordingly, the EBA proposals are relevant for IFRS 9 implementation projects.

Next steps

The deadline for comments for the EBA proposals is 22 January 2016. During the consultation period, the EBA carried out a quantitative and qualitative impact assessment of the proposals.

7. Paragraph B5.5.37 of IFRS 9.

8. Paragraph A4 of the Basel Committee's [Guidance on credit risk and accounting for expected credit losses](#) issued in December 2015.

Application update – ESMA enforcement decision

On 25 November 2015, the European Securities and Markets Authority (ESMA) published the 18th extracts from its confidential database of enforcement decisions on financial statements⁹. One decision – on the fair value measurement of fixed-rate loans – is likely to be of particular interest for banks.

Fair value measurement for fixed-rate loans

Accounting treatment subject to the enforcement decision

A bank measures certain fixed-rate loan assets at FVTPL under the fair value option of IAS 39. The bank operates in a country where no secondary market for fixed-rate loans exists.

The bank has estimated the fair value of the loans by discounting the contractual cash flows using a discount rate consisting of the observable swap rate plus an unobservable margin. The margin was calculated by taking into account the funding mark-up, the rate of return on equity and assumptions regarding normalised losses and operating costs of a potential market participant. The calculated margin was the same for all fixed-rate loans, regardless of their maturity.

In the country where the bank operates, a public register publishes the lending rates of all types of loans, sorted by the level of collateral provided and maturities. The discount rate calculated by the bank and used to measure the fair value of the loans was significantly below the issuer's and other banks' published lending rates. Consequently, day one profits frequently appeared.

Enforcement decision

The enforcer disagreed with the way the bank had estimated fair value and concluded that the discount rate used to determine the fair value of the loans should be calibrated to the rates observable in the retail market. The rationale for the enforcement decision included the following:

- the enforcer considered that other financial institutions in relevant jurisdictions would be potential market participants, as defined by paragraph 23 of IFRS 13 *Fair Value Measurement*;
- it did not seem reasonable to assume that a market participant would be willing to buy an existing fixed-rate loan for a significant premium when they could obtain the same cash flows by issuing the same loan directly;
- paragraph 61 of IFRS 13 requires an issuer to maximise the use of relevant observable inputs and minimise the use of unobservable inputs when using a valuation technique; and
- paragraph AG76 of IAS 39 states that the best evidence of the fair value of a financial instrument on initial recognition would normally be the transaction price.

Other decisions

The other published enforcement decisions were on the following topics: presentation of licensed activities as discontinued operations, disclosures in interim financial statements, disclosures on post-employment benefit plans, going concern disclosures, control of an entity without holding any equity interest, de facto control, impairment of goodwill, carrying amounts of a cash-generating unit to be tested for impairment, and presentation and disclosure of discontinued operations in separate financial statements.

9. [ESMA/2015/1776](#).

The proposed revisions are based on IFRS 9 as issued by the IASB and will be finalised once IFRS 9 is endorsed by the EU.

EBA consults on the IFRS 9 impact on FINREP

On 8 December 2015, the EBA issued a [consultation paper](#) on updating the supervisory reporting of institutions with regard to financial reporting (FINREP) for IFRS 9¹⁰.

European credit institutions subject to FINREP are required to use IFRS endorsed by the EU for regulatory reporting. This means that FINREP needs to be updated whenever the relevant endorsed international accounting standards are changed. The EBA's consultation paper aims to collect industry views on changes to FINREP IFRS resulting from the publication of IFRS 9 in July 2014.

The proposed amendments to the FINREP IFRS templates reflect the changes to:

- the classification and measurement of financial assets;
- accounting for impairment of financial assets; and
- hedge accounting.

The proposed revisions are based on IFRS 9 as issued by the IASB and will be finalised once IFRS 9 is endorsed by the EU. The EBA notes that the endorsement process for IFRS 9 is still ongoing.

Assuming an effective date for IFRS 9 in the EU of 1 January 2018, the first application date for the proposed amendments would be 1 January 2018 and the first reference date 31 March 2018.

The consultation period ends on 8 March 2016.

10. *Draft Implementing Technical Standards amending Commission Implementing Regulation (EU) 680/2014 on supervisory reporting of institutions with regard to financial reporting (FINREP) following the changes in the International Accounting Standards (IFRS 9).*

You may also be interested to read...

Insights into IFRS: 12th Edition 2015/16



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

September 2015

IFRS Newsletter: Financial Instruments – Issues 26 and 27



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

September and October 2015

First Impressions: IFRS 9 *Financial Instruments*



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

September 2014

IFRS Newsletter: IFRS 9 Impairment – Issue 3



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

December 2015

First Impressions: IFRS 16 *Leases*



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

January 2016

IFRS Newsletter: Insurance – Issues 49 and 50



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

October and November 2015

Click on the images above to access the publications.

Banking contacts

Global Head of Banking

David Sayer

T: +44 20 7311 5404

E: david.sayer@kpmg.co.uk

Argentina

Mauricio Eidelstein

T: + 54 11 43165793

E: geidelstein@kpmg.com.ar

Australia

Adrian Fisk

T: +61 2 9335 7923

E: adrianfisk@kpmg.com.au

Bermuda

Craig Bridgewater

T: +1 441 294 2647

E: craigbridgewater@kpmg.bm

Brazil

Fernando Alfredo

T: +55 11 21833379

E: falfredo@kpmg.com.br

Canada

Abhimanyu Verma

T: +1 416 777 8742

E: averma@kpmg.ca

China

Walkman Lee

T: +86 10 8508 7043

E: walkman.lee@kpmg.com

France

Jean-François Dandé

T: +33 1 5568 6812

E: jeanfrancoisdande@kpmg.fr

Germany

Andreas Wolsiffer

T: +49 69 9587 3864

E: awolsiffer@kpmg.com

Global Head of Capital Markets

Michael J Conover

T: +1 212 872 6402

E: mconover@kpmg.com

India

Manoj Kumar Vijai

T: +91 22 3090 2493

E: mkumar@kpmg.com

Ireland

Jonathan Lew

T: +353 1 410 1483

E: Jonathan.lew@kpmg.ie

Israel

Danny Vitan

T: +972 3 684 8000

E: dvitan@kpmg.com

Italy

Roberto Spiller

T: +39 026 7631

E: rspiller@kpmg.it

Japan

Tomomi Mase

T: +81 3 3548 5102

E: Tomomi.Mase@jp.kpmg.com

Korea

Michael Kwon

T: +82 2 2112 0217

E: ykwon@kr.kpmg.com

Mexico

Ricardo Delfin

T: +52 55 5246 8453

E: delfin.ricardo@kpmg.com.mx

Netherlands

Dick Korf

T: +31 206 567382

E: korf.dick@kpmg.nl

Portugal

Ines Viegas

T: +31 206 567334

E: iviegas@kpmg.com

Singapore

Reinhard Klemmer

T: +65 6213 2333

E: rklemmer2@kpmg.com.sg

South Africa

Vanessa Yuill

T: +27 11 647 8339

E: vanessa.yuill@kpmg.co.za

Spain

Ana Cortez

T: +34 91 451 3233

E: acortez@kpmg.es

Sweden

Anders Torgander

T: +46 8 7239266

E: anders.torgander@kpmg.se

Switzerland

Patricia Bielmann

T: +41 58 249 4188

E: pbielmann@kpmg.com

UK

Colin Martin

T: +44 20 73115184

E: colin.martin@kpmg.co.uk

US

Michael Hall

T: +1 212 872 5665

E: mhhall@kpmg.com

Acknowledgements

We would like to acknowledge the efforts of the principal authors of this publication:

Ewa Bialkowska, Colin Martin and Nicholas Murphy.

Publication name: *The Bank Statement*

Publication number: Issue 20

Publication date: January 2016

© 2016 KPMG IFRG Limited, a UK company, limited by guarantee. All rights reserved.

KPMG International Standards Group is part of KPMG IFRG Limited.

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

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

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

kpmg.com/ifrs

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

If you would like further information on any of the matters discussed in this Newsletter, please talk to your usual local KPMG contact or call any of KPMG firms' offices.