Q3 2017 NEWSLETTER

KPMG

The Bank Statement

IFRS – Global Banking Newsletter

"Banks have to be mindful of the differences between IAS 39 and IFRS 9 in accounting for modifications and revise their accounting policies where appropriate."

– **Ewa Bialkowska and Hakob Harutyunyan**
KPMG in the UK

Modification of financial instruments

Welcome to the Q3 2017 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 has completed its deliberations on the exposure draft (ED) *Prepayment Features with Negative Compensation* – see page 2.

Modification of financial instruments – Does it change under IFRS 9?

Accounting for modifications of financial instruments has been a topic of discussion for some time. The publication of IFRS 9 *Financial Instruments* has put an additional spotlight on it, so in this issue we discuss the accounting under IFRS 9 – see page 6.

How do you compare? IFRSs issued but not effective

As the implementation deadlines of IFRS 9 and other new standards are fast approaching, we look at the disclosures on the impact of IFRS 9, IFRS 15 *Revenue from Contracts with Customers* and IFRS 16 *Leases* in banks' 2017 interim financial statements – see page 11.

Regulation in action – Results of EBA's second impact study on IFRS 9

We discuss the European Banking Authority's (EBA) recently published results of its second impact study on IFRS 9 – see page 14.

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Spotlight on IFRS 9

In July 2017, the Board completed its deliberations on the ED *Prepayment Features with Negative Compensation*.

Prepayment features with negative compensation

In July 2017, the Board completed its deliberations on the ED *Prepayment Features with Negative Compensation*. The ED proposed that prepayable financial assets that would otherwise meet the 'solely payments of principal and interest' (SPPI) criterion would be eligible to be measured at amortised cost or fair value through other comprehensive income (FVOCI) – subject to the business model assessment – if the following conditions are met:

- the instrument is inconsistent with the SPPI criterion only because the party that chooses (or causes) to terminate the contract early may receive reasonable additional compensation for doing so (first eligibility condition); and
- the fair value of the prepayment feature is insignificant on initial recognition of the financial asset (second eligibility condition).

The Board made the following decisions.

- Retain the first eligibility condition that the asset should be consistent with the SPPI criterion except for the negative compensation feature and include a clarified explanation of its application in the basis for conclusions.
- Remove the second eligibility condition – i.e. that the feature should have an insignificant fair value on initial recognition.
- Clarify that the existing exception for certain prepayment features at par would accommodate reasonable negative compensation.
- Set the effective date of the amendments as annual periods beginning on or after 1 January 2019, with earlier application permitted.
- Require retrospective application subject to relevant IFRS 9 transition provisions, including relief from restating comparatives, and particular disclosures.

The Board gave the staff permission to start the balloting process with a view to issuing the final amendments in October 2017. For more information, see our *IFRS Newsletter: Financial Instruments*, July 2017.

Modification or exchange of financial liabilities under IFRS 9

This topic was discussed at the IFRS Interpretations Committee's meetings in November 2016, March 2017 and June 2017 and by the IASB in February 2017. It relates to the accounting for a modification or exchange of a financial liability measured at amortised cost that does not result in its derecognition – more specifically, whether, when applying IFRS 9, an entity recognises an adjustment to the amortised cost of the financial liability arising from such a modification or exchange in profit or loss at the date of the modification.

The Board continued to agree that following a modification that does not result in derecognition of a financial liability, an entity would recalculate the amortised cost of a financial liability by discounting the modified contractual cash flows using the original effective interest rate (EIR) and recognise any resulting adjustment in profit or loss at the date of the modification or exchange.

At its July 2017 meeting, the Board decided to describe the accounting in the basis for conclusions that will accompany the amendments to IFRS 9 relating to prepayment features with negative compensation.

For more information, see our *IFRS Newsletter: Financial Instruments*, July 2017.

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Financial assets eligible for the FVOCI election

In September 2017, the IFRS Interpretations Committee reaffirmed its previous tentative agenda decision on whether financial instruments classified as equity under paragraphs 16A–16D of IAS 32 *Financial Instruments: Presentation* are eligible for the presentation election in paragraph 4.1.4 of IFRS 9.[1]

The Committee made the following observations:

- the presentation election in paragraph 4.1.4 of IFRS 9 refers to particular investments in equity instruments and 'equity instrument' is a term defined in paragraph 11 of IAS 32;
- IAS 32 defines an equity instrument as 'any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities';
- a financial instrument that meets the definition of a financial liability cannot meet the definition of an equity instrument;
- paragraph 11 of IAS 32 states that, as an exception, an instrument that meets the definition of a financial liability is classified as an equity instrument by the issuer if it has all of the features and meets the conditions in paragraphs 16A–16B or paragraphs 16C–16D of IAS 32; and
- accordingly, a financial instrument that has all of the features and meets the conditions in paragraphs 16A–16B or paragraphs 16C–16D of IAS 32 is not eligible for the presentation election in paragraph 4.1.4 of IFRS 9, because such an instrument does not meet the definition of an equity instrument in IAS 32.

The Committee concluded that IFRS 9 provides adequate guidance in this area and decided not to add this matter to its standard-setting agenda.

GPPC paper on the risks of material misstatement of ECL under IFRS 9

The Global Public Policy Committee (GPPC) – which comprises representatives from BDO, Deloitte, EY, Grant Thornton, KPMG and PwC – has published a joint paper that seeks to help audit committees evaluate the effectiveness of their auditors' response to expected credit losses (ECLs).

The paper is designed to assist audit committees in their oversight of auditors with regard to audit work on ECLs under IFRS 9. It is addressed primarily to the audit committees of systemically important banks (SIBs). However, the principles apply in a proportionate way to other financial institutions.

For more information, see our web article.

1. Paragraph 4.1.4 of IFRS 9 permits entities to make an irrevocable election on initial recognition for particular investments in equity instruments that would otherwise be measured at fair value through profit or loss (FVTPL) to present subsequent changes in fair value in other comprehensive income (OCI).

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EBA consultation on guidelines on uniform disclosure of IFRS 9 transition arrangements

In July 2017, the EBA published a consultation on a set of guidelines specifying a uniform format for Pillar 3 disclosure requirements relating to IFRS 9. The guidelines were issued in response to proposals previously adopted by the EC on the transition period for mitigating the impact on own funds of the introduction of IFRS 9. The EC proposals (which have yet to be agreed with the European Parliament) outlined the following options for banks:

- phase in the impact of the implementation of IFRS 9 over a five-year period; or
- recognise the full impact of IFRS 9 on capital and leverage ratios from 1 January 2018 or before the end of the transition period (five-year period).

Where banks decide to phase in the impact, under the guidelines they will include in their Pillar 3 disclosures their capital and leverage ratios with and without the application of the transition arrangements. The aim of the guidelines is to ensure that institutions' Pillar 3 disclosures about capital and leverage ratios are consistent across the EU during the transition period.

The consultation period closed on 13 September 2017.

EFRAG literature review on the interaction of IFRS 9 and investment decisions

In July 2017, the European Financial Accounting and Advisory Group (EFRAG) commissioned a review of existing academic literature on the impact of accounting requirements on an entity's decision to invest and hold equity instruments in the long-term.

The literature review will provide input to EFRAG's research carried out at the request of the EC on the interaction of IFRS 9 and long-term investment decisions. The deadline for submission of proposals to EFRAG expired on 15 September 2017.

ESRB publishes a report on the financial stability implications of IFRS 9

In July 2017, the European Systemic Risk Board (ESRB) published a report on the financial stability implications of IFRS 9, in response to a request from the European Parliament. It concluded that IFRS 9 represents a major improvement in comparison to IAS 39 and is expected to bring substantial benefits from a financial stability perspective. The ESRB report also outlined policy considerations to prevent or mitigate any negative implications for financial stability.

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IASB activities affecting your bank

The Board continued its discussions on its dynamic risk management project.

Amendments to IAS 12 – Income tax consequences of payments on financial instruments classified as equity

The Board discussed feedback on the proposed amendments to IAS 12 *Income Taxes* set out in the exposure draft Annual Improvements to IFRS Standards 2015–2017 Cycle. The proposals would clarify that all income tax consequences of the distribution of profits are recognised in profit or loss, including payments on financial instruments classified as equity.

The Board decided to finalise the proposed amendments with no substantive changes. The amendments would apply to income tax consequences of dividends recognised on or after the beginning of the earliest reporting period presented.

Dynamic risk management

The Board continued its discussions on its dynamic risk management (DRM) project at the September 2017 meeting. The IASB staff presented an education session, in which it discussed prepayment risk and ways to manage it, hedge accounting and capacity.

For more information, see our *IFRS Newsletter: Financial Instruments,* September 2017.

IFRS 17 *Insurance Contracts*

In July 2017, the Board received an update on the activities targeted at investors and analysts on supporting the implementation of IFRS 17. The update included information about investor reactions to IFRS 17.

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Modification of financial instruments – Does it change under IFRS 9?

"A question was submitted to the IFRS Interpretations Committee asking for clarification of the requirements of IFRS 9 and it was debated by both the Committee and the IASB."

– **Ewa Bialkowska and Hakob Harutyunyan**
KPMG in the UK

Accounting for modifications of financial instruments has been a topic of discussion for some time. The debate has included questions such as when a modification of a financial asset leads to its derecognition and whether a modification gain or loss should be recognised if an asset or a liability is not derecognised.

The publication of IFRS 9 has put an additional spotlight on these issues. The standard introduces new guidance that indicates that if a modification of a financial liability does not result in derecognition, then a gain or loss is recognised immediately in profit or loss. Also, under the new impairment model in IFRS 9, when a financial asset is derecognised and a new one with modified terms is recognised in its place, the date of initial recognition for impairment purposes is reset to the date of modification. This means that, for example, ECL measurement on the new asset moves back to 12-month measurement (Stage 1) if it had been lifetime ECL (Stage 2) before the modification and the new asset is not credit-impaired.

Modification of financial liabilities – When is derecognition appropriate?

IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9 contain the same guidance on when a modified financial liability should be derecognised. Both require derecognition when the modification of a financial liability is substantial[2] and provide guidance on what is 'substantial'[3].

They clarify that a modification is substantial if the present value of the cash flows under the new terms is at least 10 percent different from the present value of the remaining cash flows of the unmodified financial liability, discounted in each case at the original effective interest rate. We believe that, if the difference in the present value of cash flows is less than 10 percent, then the borrower should perform a qualitative assessment to determine whether the terms of the two liabilities are substantially different.

Modification of financial liabilities – Is a gain or loss recognised?

When modification leads to derecognition

When modification of a financial liability leads to its derecognition, a gain or loss is recognised and calculated as the difference between the carrying amount of the original liability and the consideration paid – which includes recognising the modified liability at fair value.[4] This is illustrated in Example 1.

Example 1 – Calculation of gain/loss on derecognition of a financial liability

Manufacturing company M agrees with Bank B to renegotiate a loan due to B. The terms of the existing and renegotiated loans are set out in the table below. The carrying amount of the existing loan is 100 and its effective interest rate is 5%. For simplicity, we assume that there are no costs or fees associated with the restructuring.

2. Paragraphs 40 of IAS 39 and 3.3.2 of IFRS 9.
3. Paragraphs AG62 of IAS 39 and B3.3.6 of IFRS 9.
4. Paragraph 3.3.3 of IFRS 9.

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	Existing loan	Renegotiated loan
Coupon rate	5%	7.5%
Remaining maturity	1 year	5 years
Nominal amount	100	100
Fair value on initial recognition		102
Present value of the remaining cash flows (discounted at existing EIR of 5%)	100	111

No other terms have been changed.

Because the discounted present value of the cash flows under the renegotiated terms (111) is different by more than 10 percent from the discounted present value of the remaining cash flows of the existing loan (100), M derecognises the existing loan and recognises the renegotiated loan at its fair value of 102.

M recognises a loss of 2 on the renegotiation, being the difference between the carrying amount of the existing loan (100) and the fair value of the renegotiated loan (102).

When modification does not lead to derecognition

But what if the modification does not result in derecognition of the original liability? IAS 39 does not provide guidance in this area and it is a common practice not to recognise a gain or loss in this case. Instead, current practice is to adjust the EIR and amortise any gain or loss over the remaining life of the modified financial liability.

However, in copying paragraph AG8 of IAS 39 across (to paragraph B5.4.6 of IFRS 9), IFRS 9 has introduced changes to the wording, which indicate that changes to expected cash flows resulting from modifications of the contractual terms of a financial liability (that do not result in derecognition) are accounted for in the same way as changes in estimates that reflect the existing contractual terms – i.e. recognition of a gain or loss in these cases is required. In addition, IFRS 9 adds specific guidance on accounting for modifications of financial assets that do not result in derecognition, which requires recognition of a modification gain or loss.[5]

A question was submitted to the IFRS Interpretations Committee asking for clarification of the above requirements of IFRS 9 and it was debated by the Committee[6] and the IASB[7]. Both agreed that in these cases paragraph B5.4.6 of IFRS 9 requires recognition of gains or losses in the same way as for financial assets (as discussed later in this article). In July 2017, the IASB decided to highlight this in the basis for conclusions that will accompany the amendments to IFRS 9 for prepayment features with negative compensation.[8]

5. Paragraph 5.4.3 of IFRS 9.
6. November 2016, March and June 2017 meetings.
7. February 2017 meeting.
8. See our *IFRS Newsletter: Financial Instruments*, July 2017.

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Example 2 – Calculation of gain/loss when modification does not result in derecognition

Modifying Example 1, assume that the present value of the modified cash flows discounted at the original EIR of 5% is 106 and the modification is not substantial.

- Under IAS 39, a common practice would be not to recognise a gain or loss but, instead, to recognise the effect of the increased cash flows by adjusting the EIR and so spread the recognition of additional interest expense over the following five years to maturity.
- Under IFRS 9, recognition of a loss of 6 is required on the date of modification. Subsequently, M will recognise interest expense at the original EIR of 5%.

Entities should consider how to apply the guidance in IFRS 9 to a modification of a floating-rate instrument. Paragraph B5.4.5 of IFRS 9 applies to floating-rate instruments and requires changing the EIR to reflect re-estimation of cash flows due to changes in market interest rates.

Modification of financial assets – When is derecognition appropriate?

IAS 39 does not have guidance on when a modified financial asset should be derecognised, whereas IFRS 9 indicates[9] that in some cases modification of a financial asset results in its derecognition. The IFRS Interpretations Committee has considered this issue in the recent past[10] but declined to provide additional guidance.

Under IAS 39, there appears to be a consensus that a substantial modification of a financial asset leads to its derecognition. In determining whether a modification is substantial, many entities analogise to the requirements for financial liabilities and perform a qualitative and quantitative assessment to determine whether the cash flows of the original financial asset and the modified financial asset are substantially different.[11]

IFRS 9 does not provide a comprehensive analysis of the matter, but does:[12]

- state that, in some circumstances, modification of the contractual cash flows of a financial asset can lead to its derecognition;
- refer to 'a substantial modification' of a distressed asset as an example of a modification that results in derecognition; and
- include an example of a modification that does not result in derecognition, in which the gross carrying amount of the modified asset is 30 percent lower than the original loan.

9. Paragraph B5.5.25 of IFRS 9.
10. For example, in its September 2012, November 2015 and May 2016 meetings.
11. In September 2012, the IFRS Interpretations Committee discussed whether the restructuring of Greek government bonds resulted in their derecognition under IAS 39. It noted that in the absence of an explicit discussion in IAS 39 of when a modification of a financial asset results in derecognition, IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* is relevant. IAS 8 requires that, in determining an appropriate accounting policy, consideration is first given to the requirements in standards that deal with similar and related issues. On this point, the Committee noted that this requirement would lead to the development of an analogy to the notion of a substantial change of the terms of a financial liability in paragraph 40 of IAS 39.
12. Paragraphs B5.5.25–B5.5.26 and IE68–IE69 of IFRS 9.

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Does it matter if the modified asset is distressed?

Many view the modification of a distressed asset as a 'special case', because often in these cases restructuring is a means of maximising the collection of cash flows from a distressed asset by adjusting the contractual terms to reflect what the borrower can realistically pay. Does it make sense to derecognise the asset in these circumstances?

Also, IAS 39 states that if the terms of a loan, receivable or held-to-maturity investment are renegotiated because of financial difficulties of the borrower, then impairment is measured using the original EIR before the modification of terms.[13] This may be viewed as implying that the original asset continues to exist.

We believe that the holder of the financial asset should perform a qualitative and quantitative evaluation of whether the modification is substantial – i.e. whether the cash flows of the original financial asset and the modified one are substantially different. In doing so it may, but is not required to, analogise to the guidance on the derecognition of financial liabilities. However, because of the interaction between the derecognition and impairment requirements, it may not be appropriate to apply the same '10 percent test' as is required for financial liabilities.

In addition, if the holder plans to modify a financial asset in a way that will result in forgiveness of part of the asset, then it may need to write off a portion of the asset before comparing the cash flows under the original contractual terms (after write-off) and the new contractual terms.

Modification of financial assets – Is a gain or loss recognised?

Similar to financial liabilities, when modification of a financial asset leads to its derecognition a gain or loss is recognised and calculated as the difference between the carrying amount of the original asset and the consideration received, which includes the fair value of the modified asset.[14]

However, IAS 39 is not clear on whether the holder of a financial asset should recognise a gain or loss when the terms of the financial asset are modified but the asset is not derecognised. Currently, when such a modification does not involve a distressed asset, many banks adjust the EIR and do not recognise a gain or loss.

By contrast, IFRS 9 is clear that when modification of contractual cash flows does not result in the derecognition of a financial asset, the holder recalculates the gross carrying amount using the original EIR and recognises a gain or loss for the difference from the existing gross carrying amount.[15]

For example, a bank may modify the terms of a fixed-rate loan to a borrower with good credit quality for business reasons. A borrower whose credit quality has improved may approach the bank to reduce the rate, and the bank may agree in order to preserve the relationship. If the modification does not result in derecognition of the original loan, then IFRS 9 requires the bank to recognise an immediate loss on this transaction. This is because the recalculated gross carrying amount of the loan will be equal to the net present value of the modified – i.e. reduced – cash flows discounted at the original EIR.

In another example, a bank may extend the maturity of a fixed-rate loan to a good customer to meet the customer's business needs, and increase the interest rate.

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13. Paragraph AG84 of IAS 39.
14. Paragraph 3.2.12 of IFRS 9.
15. Paragraph 5.4.3 of IFRS 9.

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Any changes in accounting policies on the adoption of IFRS 9 are generally required to be applied retrospectively (subject to certain transition reliefs), which may require some effort.

If the modification does not result in derecognition of the original loan, then IFRS 9 requires the bank to recognise an immediate gain on this transaction.

As noted above, the result may be different if paragraph B5.4.5 of IFRS 9 – which requires changing the EIR of floating-rate instruments to reflect re-estimation of cash flows due to changes in market interest rates – applies.

Impact on IFRS 9 implementation projects

Banks have to be mindful of the differences between IAS 39 and IFRS 9 in accounting for modifications and revise their accounting policies where appropriate. This is likely to involve the exercise of judgement on how to interpret the requirements of IFRS 9 where explicit guidance is not provided. Banks that have modified fixed-rate financial instruments in a scenario where modification does not lead to derecognition face significant accounting change and transition adjustment.

Any changes in accounting policies on the adoption of IFRS 9 are generally required to be applied retrospectively (subject to certain transition reliefs), which may require some effort.

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How do you compare?
IFRSs issued but not yet effective

Three banks stated that the IFRS 9 quantitative impact would be disclosed in or no later than their 2017 annual reports.

In this issue, we are returning to one of the most talked about disclosure issues for banks: the impact of the adoption of IFRS 9, which is effective from 1 January 2018. We also look at disclosures of the impact relating to the implementation of IFRSs 15 and 16.

In the Q1 2017 edition of *The Bank Statement*, we reviewed disclosures provided by banks in their December 2016 annual financial statements for accounting standards that have been issued but are not yet effective – namely IFRSs 9, 15 and 16. IAS 8 has specific disclosure requirements in this area.

IAS 8 does not apply to condensed financial statements for an interim period. However, in view of the significant stakeholder interest in this topic, many entities have focused on an update to reflect the progress that they have made in their implementation projects.

Our sample of banks included all of those selected for the Q1 2017 edition. We look at updates to disclosures that those banks made in their 2017 interim financial statements.

What are the requirements?

For new accounting standards or interpretations that have been issued but are not yet effective, IAS 8 requires banks to provide certain disclosures. These disclosures include known or reasonably estimable information relevant to assessing the possible impact that the application of the new standard will have on the bank's financial statements when it is first applied.

The European Securities and Markets Authority (ESMA) noted in its public statement Issues for consideration in implementing IFRS 9 that issuers should consider whether it is useful to provide in their 2017 interim financial statements an update to information that was provided in the 2016 IFRS annual financial statements.

The Enhanced Disclosure Task Force (EDTF) also provided a tentative timeline of recommended disclosures that banks should consider for their 2017 interim financial statements, in its report Impact of Expected Credit Loss Approaches on Bank Risk Disclosures.

Our sample

Our sample consisted of 10 large international banks' June 2017 interim financial statements.

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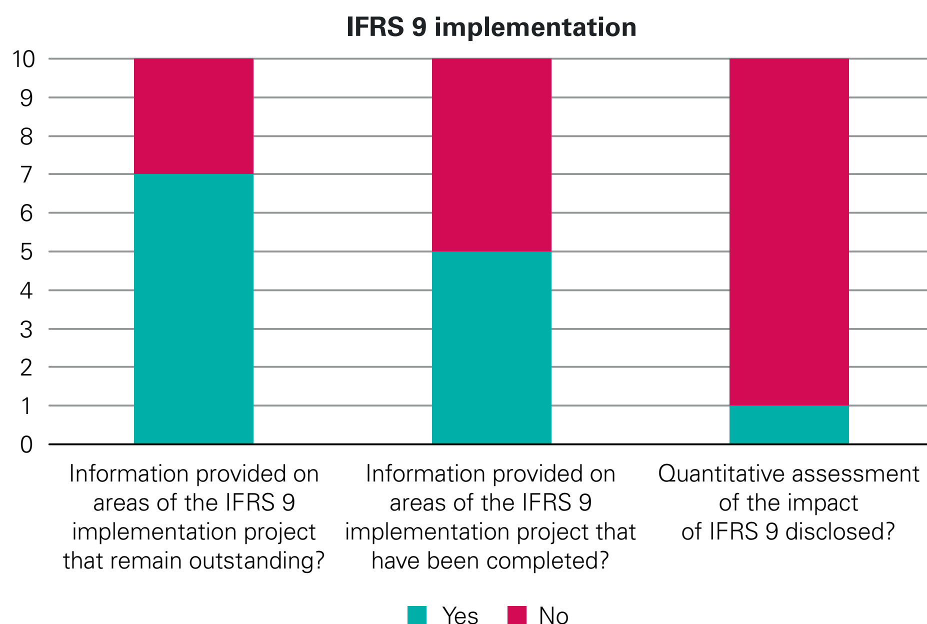
What did banks disclose?

IFRS 9

Most banks provided a brief update on their IFRS 9 implementation projects, but some largely referred to the 2016 annual financial statements. The following chart provides a summary of some disclosure themes.



IFRS 9 implementation project progress

Banks that provided more details on their project's progress noted the following areas (unless indicated, each item was disclosed by one bank).

- Completed tasks
  - Impairment model testing for substantial proportion of assets.
  - Dry run.
  - Documentation and analysis to assess classification and measurement of financial assets.
  - Approach to identification of significant increase in credit risk.
  - Incorporating forward-looking information in the impairment assessment.
  - Preparing IT systems and process architecture.
- Outstanding tasks
  - Implementation of impairment models for retail book.
  - Finalisation of the threshold for identification of a significant increase in credit risk (two banks).
  - Incorporation of multiple economic scenarios for the impairment assessment.
  - Parallel run (three banks).
  - Work related to amendments to IFRS 9 related to prepayment options.
  - Work related to governance (three banks).
  - Calibration and validation.

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- Final IT developments and tests relating to calculators and processes for collecting data.
- General rehearsal to test the new system in its entirety, including the quality of data collection.
- Rolling out training for Risk, Finance and the business.
- Enhancing the governance system.

One bank disclosed that it expected all core models to be operational by September 2017.

Disclosure of impact

Only one bank provided a quantitative impact. The estimates, which were based on the assumption that IFRS 9 was applied on 1 July 2017, included:

- increase in impairment provisions;
- increase in total assets;
- net increase in shareholders' equity after tax;
- increase in tangible net asset value per share; and
- CET 1 impact.

Of the other banks, three stated that the quantitative impact would be disclosed in (or no later than) their 2017 annual reports.

Further information on solutions adopted

Some banks provided more information on the solution adopted. This included the following.

- Impairment
  - One bank stated that measuring ECLs and the stage transfer assessment will be done on an individual asset basis, whereas another stated that they will be done on both individual and collective bases.
- Classification and measurement
  - One bank summarised the expected classification for different types of assets – e.g. loans, treasury bills, government bonds, equity investments.
  - One bank stated that it expects to apply the 'low credit risk exemption' to most debt securities, and loans to central banks, credit institutions and investment firms. This bank also stated that this threshold broadly aligns with AAA to BBB- ratings of major rating agencies.

IFRS 15

Most banks reiterated that IFRS 15 is not expected to have a significant impact on their financial statements and none disclosed quantitative information. One bank noted that it is in particular reviewing commission received from banking and similar services, revenue from property development and from services provided in connection with lease contracts.

IFRS 16

No bank disclosed quantitative information. One indicated that it expects an increase in assets and liabilities for transactions that are currently accounted for as operating leases under IAS 17 *Leases* on transition to IFRS 16.

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Regulation in action – Results of EBA's second impact study on IFRS 9

"The continued low financial impact has surprised industry commentators."

– **Steven Hall**
KPMG in the UK

The EBA has published the results of its second impact study on the implementation of IFRS 9, covering both the quantitative and qualitative aspects of its findings based on 54 banks across Europe.

Most industry observers were more interested in the quantitative findings, which contained no real shocks because they were broadly in line with the first study. This is perhaps not surprising, given that this study came fairly soon after the first one in 2016.

Quantitative impacts

As one would expect, the main driver of the quantitative impacts comes from the impairment requirements, with limited impact from the classification and measurement (C&M) changes.

In the UK, Royal Bank of Scotland (RBS) bucked the trend in its recent interim financial statement announcements, disclosing a +30bps capital gain from the C&M changes. However, the main driver of its impairment changes comes from the lifetime ECL calculated for Stage 2 assets – i.e. assets for which credit risk has increased significantly since initial recognition.

Overall, the estimated increase in provisions is lower on average than in some previous industry studies, with an estimated increase of 13 percent at the 50th percentile (compared with 18 percent in the first quantitative impact study) and 18 percent at the 75th percentile (compared with 30 percent at the 86th percentile last time). The continued low financial impact has surprised a number of industry commentators. The increase in provisions drives the impact on own funds and therefore the impact on common equity tier 1 (CET1) ratios. On average, this is a decrease of 45bps compared with 59bps estimated in the first impact study, with the biggest impacts hitting those firms that calculate capital requirements using the standardised approach to credit risk and that cannot reflect any excess provisions in Tier 2 capital. Again, the recent RBS announcements were a surprise, showing a positive impact on capital.

What does this mean?

The EBA is at pains to point out that these results don't reflect any of the potential transition rules for capital requirements that are currently being negotiated. At this stage, then, the actual treatment that will be adopted in the EU for transitional capital requirements is one of the major uncertainties as firms seek to implement effective capital planning and forecasting.

However, these point-in-time impacts are very much within expectations and are unlikely to be considered to have a significant impact on firms. What will be more interesting is the volatility of the outcomes, with nearly 75 percent of respondents believing that it will increase profit or loss volatility due to the cliff effect of moving between Stage 1 and Stage 2. Outside this EBA study, other regulators (notably the UK regulator, an active voice in the discussion, and the EBA for early 2018) are exploring how banks' regulatory capital positions will respond under stress, given the way that an expected loss approach will bring forward future losses under stress and could lead to a much bigger CET1 impact.

Qualitative considerations

Fortunately, the EBA found that most firms had made progress in their implementation programmes, with most at the build or test phase, albeit with a trend towards smaller firms lagging behind.

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As expected, firms have squeezed their parallel runs and abandoned hopes of a luxurious 12 months to road test systems, controls, data and models. With firms pushing these to six or even three months, the EBA is rightly concerned that nearly 20 percent of firms are not planning any parallel run now – the scale of changes to systems and processes to implement IFRS 9 requires significant testing and parallel runs to iron out issues, and should not be something that you leave to a wing and a prayer.

The EBA remains a strong supporter of a robust implementation of IFRS 9 and continues to push for compliance with its guidelines for implementation, which were published last year. It acknowledges that the data limitations that some firms face and the need for proxies and tactical solutions in the run-up to implementation will require considerable effort both to justify now and to remediate post-2018. It has not been as explicit as the UK regulator in putting down a marker to senior management that IFRS 9 programmes need to be planned (and budgeted) for work to continue into 2019, 2020 and potentially beyond. Increasing consistency and harmonisation of approaches as we see a shake-down of implementation methods after implementation will be key to regulators' approaches.

Next steps

In the meantime, enhanced disclosure is a must, to allow the various interested stakeholders to transition effectively from IAS 39 to IFRS 9 numbers – to understand the approaches taken, the key assumptions and the implications for the balance sheet, profit or loss and capital positions and, most importantly, the sensitivities of those under stress. Regulators have proposed that disclosures would include (among other things):

- reconciliations with explanations of the IAS 39 provisions to the IFRS 9 ECL estimates;
- the main judgements made and the quantification of the impact of those judgements; and
- the implications arising for the firm's capital position from the ECL estimate being bigger, more volatile and differently cyclical from under IAS 39.

As firms move from implementation and compliance to business implications, the EBA found indications that firms would be adapting lending standards but with little in the way of concrete changes at this stage. Our understanding is that firms are examining their pricing approaches, looking at product terms and conditions and trying to understand which products are most impacted by stress. They are also trying to get a handle on the commercial finance and operating model implications for different business units. However, at the moment, as the EBA has found, most firms are prioritising implementation and compliance over business implications and it is a case of 'all hands to the pump' to make sure they get over the line.

Bringing it all together

Given that this second study was not long after the first, it is not surprising that the conclusions are broadly consistent. At this point in the cycle, as the current economic back-drop is seen to be relatively benign, the direct impact on provisions (and therefore balance sheet, profit or loss and subsequently capital) is limited.

As we approach the mandatory effective date, the first question will be: how many firms have adopted a 'string and sticky tape' approach to pulling this all together? The second will be: how volatile will results truly be in practice and how will they respond under stressed economic conditions (in particular the capital positions)?

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Where regulation and reporting meet

The MoU will focus on the development of standards, the interaction between IFRS and the Basel Committee Framework and the manner in which they are applied in practice by financial institutions.

ESMA review of the application of IFRS 13

In July 2017, ESMA published a report providing an overview of the implementation of IFRS 13 *Fair Value Measurement* by European issuers. It builds on a previous desktop review of the 2015 financial statements of a sample of 78 issuers from different industries.

Area of focus	Key findings
Effectiveness of fair value disclosures	Issuers broadly complied with the minimum disclosures, but some disclosures were too generic or 'boilerplate' and sometimes lacked disaggregated information.
Application of the unit of account (UOA)	Disclosures were limited.
Level of market activity and fair value	Limited evidence that issuers departed from quoted prices as a result of a decrease in the level of market activity.
Valuation adjustments for derivatives	Credit valuation adjustment (CVA) information was provided by the majority of issuers with significant derivative balances, but fewer issuers provided information on debit valuation adjustment (DVA) and funding valuation adjustment (FVA).

Basel Committee and IFRS Foundation sign memorandum of understanding

In September 2017, the Basel Committee on Banking Supervision and the IFRS Foundation signed an agreement, in the form of a memorandum of understanding (MoU), with the aim of fostering long-term financial stability, enhancing market discipline and further facilitating the sharing of information.

The MoU formalises the interaction between the two bodies and aims to strengthen the relationship at the strategic and working level. It will focus on the development of standards, the interaction between IFRS and the Basel Committee Framework and the manner in which they are applied in practice by financial institutions.

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You may also be interested to read...

Insights into IFRS: 14th Edition 2017–18

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

September 2017

IFRS Newsletter: Financial Instruments – Issues 41 and 42

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

July and September 2017

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 4

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

February 2017

First Impressions: IFRS 16 *Leases*

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

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IFRS Newsletter: Insurance – Issue 57

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

March 2017

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