Q4 2017 NEWSLETTER

KPMG

The Bank Statement

IFRS – Global Banking Newsletter

"Armed with the knowledge of the likely LIBOR reforms, market participants have already started to think about the possible actions that they would need to take."

– **Shandhir Lachman and Colin Martin**
KPMG in the UK

LIBOR reforms and the accounting impacts

Welcome to the Q4 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. This is the final edition of our newsletter. We hope that you have enjoyed reading it over the past few years.

Spotlight on IFRS 9

In October 2017, the IASB issued *Prepayment Features with Negative Compensation (Amendments to IFRS 9)* – see page 2.

Accounting impacts of reforming LIBOR

We discuss the possible accounting impacts of reforming LIBOR – see page 6.

How do you compare? Capital management disclosures

In this issue, we look at capital management disclosures made by banks in their 2016 annual financial statements – see page 9.

Regulation in action – 2018 EBA EU-wide stress test: Accounting considerations

We discuss the European Banking Authority's (EBA) recently published final methodology for the 2018 EU-wide stress test – see page 10.

Where regulation and reporting meet – US tax reforms

We discuss the recent US tax reforms' potential impact on 2017 financial statements – page 13.

Spotlight on IFRS 9

The IFRS 9 amendments will allow entities to measure financial assets containing prepayment features with negative compensation at amortised cost or at FVOCI if they meet the other relevant requirements.

Prepayment features with negative compensation

In October 2017, the IASB issued narrow-scope amendments to IFRS 9 *Financial Instruments* that will allow entities to measure financial assets containing prepayment features with negative compensation at amortised cost or at fair value through other comprehensive income (FVOCI) if they meet the other relevant requirements of IFRS 9. The amendments remove the word 'additional' from the existing version of the standard so that negative compensation may be regarded as 'reasonable compensation'. The amendments are effective for annual periods beginning on or after 1 January 2019, with early adoption permitted. Application of the amendments may be subject to local endorsement processes. Retrospective application is required, subject to relevant transitional reliefs.

Modification or exchange of financial liabilities

The Board has also taken this opportunity to clarify the accounting for non-substantial modifications of financial liabilities that do not result in derecognition. The basis for conclusions of the amendments state that IFRS 9 (as issued in 2014) requires preparers to:

– recalculate the amortised cost of the modified financial liability by discounting the modified contractual cash flows using the original effective interest rate (EIR); and

– recognise any adjustment in profit or loss.

The accounting treatment is therefore consistent with that required for modifications of financial assets that do not result in derecognition. Common practice under IAS 39 *Financial Instruments: Recognition and Measurement* is to recalculate the EIR at the modification date to reflect the revised contractual cash flows, without recognising a gain or loss at that date. If the initial application of IFRS 9 results in a change in accounting policy for these modifications or exchanges, then retrospective application is required, subject to particular transitional reliefs.

For more information, see our web article.

EFRAG's endorsement advice on prepayment features with negative compensation (amendments to IFRS 9)

In November 2017, the European Financial Reporting Advisory Group (EFRAG) completed its due process regarding *Prepayment Features with Negative Compensation (Amendments to IFRS 9)* and submitted its endorsement advice letter to the European Commission. EFRAG assessed that the amendments to IFRS 9 met all of the relevant technical endorsement criteria and are conducive to the European public good. EFRAG therefore recommended endorsement of the amendments.

Webcast on the implementation of disclosures related to IFRS 9

In October 2017, the IASB staff presented a webcast that discussed at a high level the key disclosure requirements introduced by IFRS 9 and noted that:

– the requirements in IFRS 9 are different from those in IAS 39 in many aspects and, for some, will result in a significant change in the information provided in the financial statements; and

– high-quality disclosures are important for investors and others to understand what has changed in the transition from IAS 39 to IFRS 9, and to understand the basis for the new amounts reported in the financial statements.

Long-term interests in associates and joint ventures

In October 2017, the IASB issued a narrow-scope amendment to IAS 28 *Investments in Associates and Joint Ventures*. The amendment states that long-term interests in associates and joint ventures are in the scope of both IAS 28 and IFRS 9, and clarifies how the loss absorption and impairment requirements of the two standards interact. The IASB also published an example that illustrates how to apply the requirements in IFRS 9 and IAS 28 to long-term interests in an associate or joint venture.

To learn more about the amendments, read our web article.

Presentation of interest revenue

In November 2017, the IFRS Interpretations Committee discussed the consequential amendment that IFRS 9 made to paragraph 82(a) of IAS 1 *Presentation of Financial Statements*. That paragraph requires an entity to present in a separate line, in the profit or loss section of the statement of comprehensive income or in the statement of profit or loss, interest revenue calculated using the effective interest method.

The request submitted to the Committee asked whether this requirement affects the presentation of fair value gains and losses on derivative instruments that are not part of a designated and effective hedging relationship in accordance with IFRS 9 or IAS 39.

The Committee noted that amortised cost accounting, including calculation of interest revenue using the effective interest method and the expected credit loss impairment model, is applied only to financial assets that are subsequently measured at amortised cost or FVOCI and is not applied to financial assets subsequently measured at fair value through profit or loss (FVTPL). The Committee did not consider whether an entity could present other interest amounts in the statement of comprehensive income, in addition to presenting the interest revenue line item required by paragraph 82(a) of IAS 1.

The Committee tentatively concluded that:

– the requirement in paragraph 82(a) of IAS 1 applies only to those assets that are subsequently measured at amortised cost or FVOCI (subject to any effect of a qualifying hedging relationship in IFRS 9 or IAS 39); and

– the principles and requirements in IFRS provide an adequate basis for an entity to apply that paragraph.

The Committee tentatively decided not to add this matter to its standard-setting agenda.

IFRS 9 capital transitional arrangements

In November 2017, the European Parliament reached agreement, ahead of the official publication, on the transitional capital arrangements for mitigating the impact of the introduction of IFRS 9 on own funds. Banks can choose whether to apply these arrangements and may also reverse their initial decision, subject to supervisory permission.

Under the transitional arrangements, banks can add back the following reductions in Common Equity Tier 1 (CET1) capital resulting from the application of IFRS 9:

- 2018 – 95 percent;
- 2019 – 85 percent;
- 2020 – 70 percent;
- 2021 – 50 percent; and
- 2022 – 25 percent.

Banks that decide to apply the arrangements will have to disclose their own funds, capital ratios and leverage ratios both with and without the application of the arrangements. These arrangements will apply from 1 January 2018 in line with IFRS 9's effective date.

ECB thematic review of IFRS 9

In November 2017, the European Central Bank (ECB) published the findings of its thematic review on IFRS 9. The report assessed the preparedness of institutions for the introduction of IFRS 9 and the potential impact on provisioning, and aimed to promote consistent application of the new standard. The review included all significant institutions that are directly supervised by the ECB and a sample of less significant institutions.

Based on the information provided by institutions at an advanced stage of implementation, the fully loaded average negative impact on the regulatory CET1 ratio is estimated to be:

- 40 basis points for the significant institutions; and
- 59 basis points for the less significant institutions.

The report explained that one possible explanation of the difference in impact is the fact that large banks rely more on internal models to calculate credit-risk capital requirements, whereas smaller banks rely more on standardised models.

The report found that many institutions still have to reinforce their governance of expected credit loss (ECL) models and improve their accounting policies, which are often too vague. Improvements are also needed in application of the 'solely payment of principal and interest' (SPPI) test, definition of default, determining significant increase in credit risk, incorporating forward-looking information into ECL measurement, validation and back-testing.

The report states that the supervisors will closely monitor the progress of institutions' implementation of IFRS 9.

IASB activities affecting your bank

The Board discussed two proposed approaches for a dynamic risk management accounting model.

Dynamic risk management

The Board continued its discussions on its dynamic risk management (DRM) project at the November 2017 meeting and discussed two proposed approaches for a DRM accounting model. It discussed the objectives of the model and whether it should follow cash flow hedge mechanics or fair value hedge mechanics. The Board tentatively agreed that a model based on cash flow hedge mechanics should be developed. The staff will present a project plan at the next Board meeting.

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

Accounting impacts of reforming LIBOR

"With the likely reforms to LIBOR on the horizon, banks should consider the possible accounting impacts."

– **Shandhir Lachman and Colin Martin**
KPMG in the UK

Over the past few decades, the London inter-bank offered rate (LIBOR) has been a cornerstone of the global financial markets. However, in a recent speech[1] the chief executive of the Financial Conduct Authority (FCA) in the UK indicated that market participants should prepare for the likelihood that LIBOR will cease to exist in its current form by the end of 2021 and stated that "the survival of LIBOR on the current basis, as a dynamic benchmark based on daily submissions and updates, could not and would not be guaranteed". The FCA noted that it was difficult to anchor LIBOR submissions and rates to actual transactions that are representative of market conditions and that this brought into question the sustainability of LIBOR benchmarks. With LIBOR-referenced contracts of approximately $300 trillion in issue across the world, a shift away to an alternative benchmark rate will not be an easy task for various market participants. This article explores some of the potential accounting impacts.

Hedge accounting considerations

Maintaining hedging relationships

One issue to consider is the impact on existing hedging relationships as a result of the expected reforms to LIBOR. In particular, if an entity had hedge designations whereby changes in LIBOR were designated as the hedged risk, then a question arises whether hedge accounting should be discontinued because of a change in the benchmark interest rate away from LIBOR. Under IFRS 9, hedging relationships that no longer meet the qualifying criteria are discontinued after taking into account the impact of rebalancing where applicable. Circumstances that would require discontinuation of the hedging relationship include a change in the risk management objective of the hedging relationship, the expiry, sale or termination of the hedging instrument and when there is no longer an economic relationship between the hedged item and hedging instrument.

Forecast transactions

Another issue to consider is the impact of the expected reforms to LIBOR on highly probable forecast transactions under a cash flow hedge model. IFRS 9 permits the application of cash flow hedge accounting to highly probable forecast transactions and requires that these forecast transactions present an exposure to variations in cash flows that could ultimately affect profit or loss. A forecast transaction is generally considered to be highly probable if the transaction has at least a 90 percent probability of occurring. However, other facts and circumstances relating to the transaction should also be considered – e.g. how far into the future the transaction is expected to occur. Under IFRS 9, when a forecast transaction is no longer highly probable the criteria for hedge accounting are no longer met and an entity therefore ceases applying hedge accounting prospectively.

In this regard, a question arises over the potential impact of the future withdrawal of LIBOR, or its ceasing to exist 'in its current form', on the assessment of whether a LIBOR-based forecast transaction is 'highly probable'. Some factors to consider when undertaking the 'highly probable' assessment under IFRS 9 include evaluating whether banks continue to provide LIBOR quotes (even though they may not be compelled to do so) and assessing whether there is potential for alternative definitions of LIBOR to be adopted.

1. The future of LIBOR.

Hedge effectiveness

The expected LIBOR reforms may also have an impact on the hedge effectiveness assessment for hedging relationships. Hedge effectiveness (and ineffectiveness) measures the extent to which changes in the fair value or cash flows of the hedging instrument offset changes in the fair value or cash flows of the hedged item for the hedged risk.

Hedge ineffectiveness may arise in the future if derivatives (which are likely to be changed in bulk through changes to standard contracts) are changed to a reference rate or have different reset dates from hedged items (which are likely to be amended bilaterally). The potential illiquidity of both LIBOR instruments over the period when LIBOR is being reformed and instruments referenced to any new benchmark rate replacing LIBOR may also result in hedge ineffectiveness.

Modifications

Another issue to consider is the impact of reforming LIBOR on both financial liabilities (e.g. corporate debt issued) and financial assets (e.g. retail loans originated). In particular, a question arises whether the change in the benchmark rate represents a modification of the terms of an existing contract.

A modification that is considered substantial results in the derecognition of the financial asset or financial liability. Other modifications require a gain or loss to be calculated and recognised in profit or loss.

IFRS 9 has specific requirements relating to the modification of both financial liabilities and financial assets (see the Q3 2017 edition of *The Bank Statement*).

Importantly, modification accounting would not apply to the extent that a change in the benchmark rate was a clause that was included in the original contract of the debt instrument and, therefore, a change of contract was not necessary. Equally, if LIBOR is redefined to be something else, then the contract itself that references 'LIBOR' but does not define it in detail may not need a modification at all.

Discounting

IFRS 13 *Fair Value Measurement* sets out a framework for measuring fair value and includes guidance on the use of present value techniques. When applying these techniques, there are instances in which LIBOR would be used as a proxy for the risk-free rate of interest for valuation purposes – e.g. when measuring the fair value of certain over-the-counter (OTC) financial instruments. The likely reforms to LIBOR may necessitate a change in the discount rate used for fair value measurements because an alternative benchmark may better approximate a risk-free rate and it remains to be seen whether there will be any divergence in fair values as a result of the change.

The expected LIBOR reforms may also impact the measurement of employee benefit obligations under IAS 19 *Employee Benefits*, if the discount rate used in the measurement of the obligation is based on high-quality corporate bonds with yields referenced to LIBOR.

Moving forward

In his speech, the FCA chief executive stated that "we do not think markets can rely on LIBOR continuing to be available indefinitely". It is expected that by 2021, the FCA will no longer be able to compel banks to provide inputs into determining the benchmark interest rate as we currently see it. Armed with the knowledge of the likely LIBOR reforms, market participants have already started to think about the possible actions that they would need to take. Steps are already under way to develop alternative benchmark rates and there have been discussions on improving the fall-back provisions in new contracts to facilitate an easier conversion to an alternative benchmark rate if required. As part of these preparations, it is also important for banks to carefully consider the various accounting issues discussed in this article.

How do you compare? Capital management disclosures

Audited capital disclosures were principally located outside the financial statements, mainly in the risk report.

In this issue, we look at capital management disclosures made by banks as part of their audited 2016 annual financial statements.

What are the requirements?

IAS 1 requires disclosure of "information that enables users of financial statements to evaluate the entity's objectives, policies and processes for managing capital". This includes, inter alia, disclosure of:

– "qualitative information about its objectives, policies and processes for managing capital, including:
  - a description of what it manages as capital;
  - when an entity is subject to externally imposed capital requirements, the nature of those requirements and how those requirements are incorporated into the management of capital; and
  - how it is meeting its objectives for managing capital; and
– summary of quantitative data about what is managed as capital" (paragraph 135).

Our review related only to information covered by the auditors' report on the annual financial statements. This information was sometimes included within the audited financial statements and sometimes in other sections of the annual report but marked as audited. If information was included in an annual report but not marked as audited then we did not include it in our review.

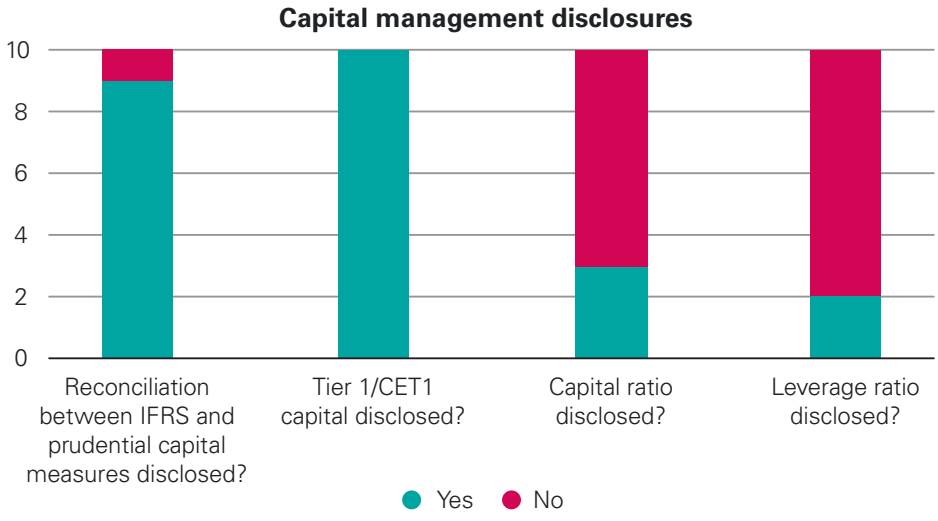
Our sample

Our sample consisted of 10 large international banks' December 2016 annual financial statements.

What did banks disclose?

Audited capital disclosures were principally located outside the financial statements, mainly in the risk report – only three banks in our sample included them in notes to the financial statements. The length of the disclosures varied: three banks provided one page or less, whereas one provided five pages.

The graph below illustrates the types of quantitative information disclosed.



Regulation in action – 2018 EBA EU-wide stress test

The EBA stress test methodology for the first time incorporates IFRS 9.

In November 2017, the EBA published its final methodology for the 2018 EU-wide stress test. The stress test aims to assess the impact on banks' capital position (CET1) of a given baseline and adverse scenarios. It will be applied to approximately 50 large banks covering around 70 percent of the EU banking sector.

The methodology for the first time incorporates IFRS 9. However, in this regard it contains certain requirements that may be different from the ones adopted by a bank for its financial statement reporting. The table below outlines some of the differences.

EBA stress test methodology	IFRS 9
"*No workout or cure of S3[2] assets is assumed in the exercise*" (paragraph 28)	If the definition of credit-impaired is no longer met, then the asset is transferred to another ECL category – e.g. lifetime or potentially 12-month ECL measurement (referred to under the stress test methodology as S2 and S1 assets respectively). In practice, consideration of a cure period is usually appropriate – that is, a period necessary for the borrower to demonstrate that concerns about its meeting all contractual obligations have reduced significantly before an asset is treated as not credit-impaired.
"*A common definition of S3 assets as non-performing exposures should be applied for the projections*" (paragraph 41)	IFRS 9 defines a credit-impaired asset as one in respect of which "one or more events that have a detrimental impact on the estimated future cash flows of the financial asset have occurred" (Appendix). This may not fully align with the regulatory definition of non-performing.
"*However, for the purpose of the stress test projections banks shall also assume without prejudice to other triggers that S1 exposures that experience a threefold increase on lifetime PD (as defined by IFRS 9) compared to the corresponding value at initial recognition have undergone a significant increase in credit risk and hence become S2*" (paragraph 51)	IFRS 9 does not have a quantitative threshold for assessing if there has been a significant increase in credit risk since initial recognition.

2. Stage 3 assets are those defined in IFRS 9 as credit-impaired.

EBA stress test methodology	IFRS 9
"*For the purpose of the stress test, an Instrument may be considered to be of low credit risk in a particular year, T, of the stress test if the instrument's TR[3](1-3)(t) for that year is less than 30%*" (paragraph 51)	Under paragraph B5.5.22 of IFRS 9, "credit risk is considered to be low if the instrument has a low risk of default, the borrower has a strong capacity to meet its contractual cash flow obligations in the near term and adverse changes in economic and business conditions in the longer term may, but will not necessarily, reduce the borrower's ability to fulfil its obligations". An external rating of investment grade is an example of a financial instrument that may be considered as having low credit risk.
"*For the avoidance of doubt, FVOCI and FVPL positions are excluded from the estimation of credit losses*" (paragraph 45)	Debt instruments that are measured at FVOCI are in the scope of the impairment requirements of IFRS 9. However, because the impairment amount recognised in profit or loss is offset by an equal and opposite amount recognised in OCI, there is no overall impact on equity.

The stress test exercise will be formally launched this month, with the first submission of results to the EBA in June 2018. The results are expected to be published by 2 November 2018.

3. Transition rates.

Where regulation and reporting meet

One of the priorities is the disclosure of the expected impact of the implementation of IFRS 9 in the period of its initial application.

ESMA common enforcement priorities for 2017

On 27 October 2017, the European Securities and Markets Authority (ESMA) published its annual *Public Statement on European common enforcement priorities for 2017 financial statements*. One of the priorities is the disclosure of the expected impact of the implementation of IFRS 9 in the period of its initial application.

ESMA expected that, because the 2017 annual financial statements will be published after the effective date of IFRS 9, issuers will have substantially completed their implementation analyses. Therefore, it expects that at the time of the preparation of the 2017 accounts the impacts of IFRS 9 will be known or can reasonably be estimated and should be disclosed. Such disclosures should include sufficiently disaggregated information on both:

- accounting policy choices expected to be applied, including those relating to the transition approach and the use of practical expedients; and
- the amount and nature of the expected impacts compared with previously recognised amounts.

ESMA also stated that issuers should focus on disclosing concise, entity-specific descriptions of the changes introduced by IFRS 9 and avoid boilerplate disclosures.

The statement also included other recommendations on the application of IFRS 9, including the following.[4]

Category	Detailed recommendations on the disclosure of the impact of IFRS 9
General considerations	– Accounting for a modification of a financial liability that does not result in derecognition may differ from the predominant accounting treatment under IAS 39. Where the difference is material, issuers should provide separate disclosure explaining the change and its impact on the accounting for financial liabilities existing at 31 December 2017 that were modified under IAS 39.
Credit institutions	– Disclosures should be sufficiently disaggregated – e.g. separating the quantitative impact from classification and measurement, impairment and hedge accounting – and should explain the main drivers of the most significant impacts. – If the requirement related to the presentation of gains and losses on financial liabilities designated as at FVTPL in accordance with paragraph 7.1.2 of IFRS 9 has been applied early, then separate disclosure of its quantitative impact should be provided under paragraph 28 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors.* – Entities for which the amendments to IFRS 9 on prepayment features with negative compensation[4] are expected to result in a material impact should explain the impact where practicable. Subject to the EU's endorsement, ESMA encourages such credit institutions to apply the amendments early.

4. *Prepayment Features with Negative Compensation (Amendments to IFRS 9).*

Category	Detailed recommendations on the disclosure of the impact of IFRS 9
Credit institutions (continued)	– Disclosures should be provided on applying judgement in the key areas of the standard – e.g.: - *for classification of financial assets:* which sales are expected to be consistent with held-to collect business models; and - *for ECL:* the assessment of significant increase in credit risk, definition of default and incorporation of forward-looking information.

Consultation on draft addendum to ECB's guidance on non-performing loans

In October 2017, the ECB published a consultation on a draft addendum to its guidance on non-performing loans (NPLs). The draft addendum supplements and reinforces the NPL guidance published in March 2017 with regard to timely provisioning and write-off practices.

The draft addendum specifies quantitative supervisory expectations for minimum levels of prudential provisions for new NPLs, which will apply to all exposures that are newly classified as non-performing in line with the EBA definition as of 1 January 2018.

Although the document covers some similar ground to the impairment requirements of IFRS 9, it states that it is not intended to substitute or supersede any of the relevant accounting requirements. The document encourages banks to close potential gaps relative to the prudential minimum expectations by booking the maximum level of provisions possible under the applicable accounting standard. The ECB expects that, where banks book accounting provisions in line with the existing accounting principles, in the vast majority of cases the prudential backstop should not have any effect.

The consultation period expired on 8 December.

Given that IFRS requires companies to use currently enacted tax laws and rates in their 2017 financial statements, time is of the essence to understand these complex tax changes and to estimate their impact.

US tax reforms

In December 2017, major changes were introduced to tax legislation in the US. These changes are numerous and complex and could have a significant impact on the 2017 financial statements of any company with operations in the US.

The changes include, but are not limited to:

– a reduction of the corporate tax rate from 35 percent to 21 percent;

– a repeal of the corporate alternative minimum tax;

– a revision to the current 'worldwide' system of multinational taxation; and

– business tax reforms that may affect the recognition of deferred tax.

Given that IFRS requires companies to use currently enacted tax laws and rates in their 2017 financial statements, time is of the essence to understand these complex tax changes and to estimate their impact.

Potential impact

The changes in tax law include various provisions that affect the calculation of current and/or deferred tax that, given the enactment of the legislation before the year end, have to be considered in preparing financial statements under IFRS. The impact of each change in tax law will depend on a bank's specific facts and circumstances, and will need to be analysed individually.

In some cases, the impact will be easy to calculate. In other cases, in applying the new tax law, we fully expect that a bank will make its best estimate, and may revise that estimate in future periods as a result of new or better information, clarifications of the application of tax laws and/or more experience. In all cases, the financial statements should include appropriate disclosures, including relevant information about major sources of estimation uncertainty in applying the new tax law.

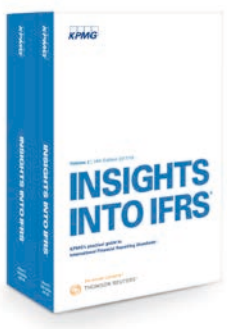
Specific areas that may affect banks include the following.

Area of impact	Description of impact
Remeasurement of deferred taxes	– Companies will need to remeasure existing deferred tax assets and liabilities to reflect the change in the corporate rate from 35 percent to 21 percent. – Because many banks have large deferred tax assets for unused losses incurred during the financial crisis, this change could significantly increase their 2017 income tax expense.
Deemed repatriation of overseas profits	– Profits earned by foreign subsidiaries of US entities will be deemed to have been repatriated to the US. – Companies will have eight years to pay any additional tax due, but the additional tax due will need to be reflected in the 2017 financial statements. – Banks with US operations that own foreign subsidiaries with undistributed earnings will be affected.

For more information read our publication.

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).

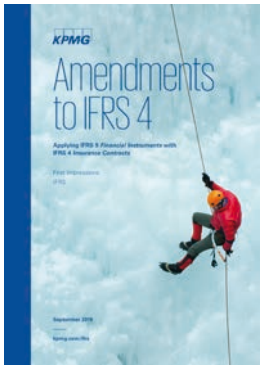
September 2017

IFRS Newsletter: Financial Instruments – Issue 43

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

November 2017

First Impressions: *Amendments to IFRS 4*



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

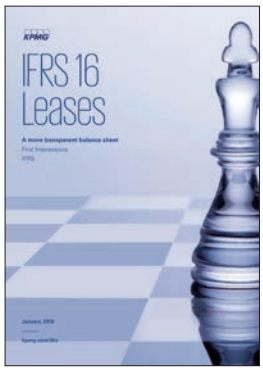
September 2016

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.

January 2016

IFRS Newsletter: Insurance – Issue 57

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

March 2017

Click on the images above to access the publications.

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***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.