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Centre for Financial
Reporting Reform



WORLD BANK GROUP



Informing the reading of IFRS Financial Statements: A guide for banking and financial supervisors

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COVER NOTE

OBJECTIVES

The objective of this guide is to provide suggested practices and examples of specific accounting and auditing issues and questions that supervisors need to consider when monitoring and reviewing banking sector financial statements.¹ This guide aims to enable prudential supervisors to form an understanding of a bank's business drivers, risks and critically evaluate the quality of financial assets and the related provisions for credit losses using IFRS financial statements.

This guide reflects the experience from a number of risk-based financial statement compliance reviews

performed as a component of World Bank Reports on the Observance of Standards and Codes (ROSC) in Accounting and Auditing (A&A).

The guide also lists regulatory areas which are connected with accounting requirements which supervisors may investigate further when reviewing financial statements.

This guide is not a checklist and should not be used as a checklist with a box ticking approach. Instead, this guide should be used as a reference document that highlights a number of relevant accounting and auditing issues that could be relevant to the work of supervisors and regulators when they review financial statements.

The guide uses a 3 level approach to enable supervisors to review financial statements:

¹ This is the first public edition of this guide, the preparation of which was led by Pascal Frerejacque, Senior Operations Officer, with the participation of Michael Wells, Kumar Dasgupta, and Ecaterina Gusarova, consultants, World Bank Centre for Financial Reporting Reform. This guide also builds on previous training materials prepared in 2016 and 2019 by the same team with inputs of Shamim Diouman, consultant. Kumar Dasgupta focused primarily on IFRS aspects included in the technical appendices. Ecaterina Gusarova prepared the graphic design of the document.

- i. High level suggested practices for supervisors to adopt when reviewing financial statements;
- ii. Questions and discussions points for supervisors to consider when meeting banks and their external auditors; and
- iii. Financial statements disclosures and audit report items for supervisors to review and monitor.

In addition, given the critical importance of financial instrument accounting for banks, the guide also includes an Appendix outlining the key IFRS 9 requirements including suggested practices from a prudential supervision perspective. The Appendix also includes a summary of the recommendations from the Basel Committee on Banking Supervision of IFRS 9 Expected Credit Loss and Pillar 3 disclosures on Market Risk.

Supervisors have a key role to play when reviewing financial statements of banks. In particular, the Basel Committee on Banking Supervision (BCBS) Core Principles for Effective Banking Supervision (BCPs)² specifically mention in BCP 27 and BCP 28:

PRINCIPLE 27: FINANCIAL REPORTING AND EXTERNAL AUDIT

The supervisor determines that banks and banking groups maintain adequate and reliable records, prepare financial statements in accordance with accounting policies and practices that are widely accepted internationally and annually publish information that fairly reflects their financial condition and performance and bears an independent external auditor's opinion. The supervisor also determines that banks and parent companies of banking groups have adequate governance and oversight of the external audit function.

PRINCIPLE 28: DISCLOSURE AND TRANSPARENCY

The supervisor determines that banks and banking groups regularly publish information on a consolidated and, where appropriate, solo basis that is easily accessible and fairly reflects their financial condition, performance, risk exposures, risk management strategies and corporate governance policies and processes.

Under BCP 27, the supervisor determines that banks use valuation practices consistent with accounting standards widely accepted internationally. The supervisor also determines that the framework, structure and processes for fair value estimation are subject to independent verification and validation, and that banks document any significant differences between the valuations used for financial reporting purposes and for regulatory purposes.

In addition, European Securities and Markets Authority (ESMA) has published ESMA Guidelines on enforcement of financial information³ "to establish consistent, efficient and effective supervisory practices and to ensure the common, uniform and consistent application of Union law reinforcing a common approach, as noted in recital 16 of the IAS Regulation, to the enforcement of financial information under the Transparency Directive in view of achieving a proper and rigorous enforcement regime to underpin investors' confidence in financial markets and to avoid regulatory arbitrage."

In order to fulfil the requirements of these specific BCPs and ESMA Guidelines, supervisors of banks need to be aware of the specific accounting and disclosure requirements that apply to banks. This is particularly the case in areas requiring preparers and auditors to exercise significant judgment such as in the valuation of complex financial instruments and the calculation of impairment for loan portfolios.

Other important areas where the comparison of banks' financial statements and prudential returns require special consideration by supervisors are the review and analysis of risk disclosures and going concern disclosures.

Finally, in the above critical areas, supervisors should have a good understanding in the role and responsibilities of auditors when the latter audit the financial statements.

Comparing accounting and regulatory treatments and disclosures are critical to an effective role of the supervisors. There are direct and indirect linkages between the accounting and auditing frameworks. These linkages impact the regulatory capital and capital buffers.

This note explains the approach and lists suggested practices that supervisors should use to review, compare and contrast the accounting and regulatory requirements. It includes practical examples of steps that supervisors could take and questions they can ask to preparers and auditors to perform this comparison.

² Core Principles for Effective Banking Supervision-BIS-September 2012

³ ESMA Guidelines on Enforcement of Financial Information-ESMA-October 2014

It is not an exhaustive list of suggested practices and examples. Supervisors should continuously update the document in line with developments in the accounting and regulatory frameworks.

The work of other regulators such as the European Banking Authority (EBA) may indicate potential areas of focus for regulation domestically. Furthermore, knowledge of the regulatory actions and decisions of fellow regulators likely brings consistency to the regulation of financial statements.

National regulators and supervisors should regularly consider and review the publications of international (e.g. BCBS and IOSCO⁴), regional (e.g. EBA and ESMA) and select other (e.g. JSE⁵) regulatory authorities, for example, to ensure that the application of International Financial Reporting Standards (IFRS) requirements are appropriate and consistent across jurisdictions.

SUMMARY OF APPROACH

The guide's 7 key suggested practices for supervisors to adopt are:

1

Understand the economic and business environment the bank operates in.

2

Understand the group structure, business models and risk profile of the bank.

3

Identify areas of focus: significant balance sheet items (and 'off-balance sheet' items), critical sources of income and key risks.

4

Understand the relevant accounting: classification, recognition (and derecognition), measurement, presentation (and disclosure).

5

Review the key accounting policies, assumptions and inputs used by senior management.

6

Question the relevance and appropriateness of the data and assumptions used by senior management.

7

Assess the impact of key accounting requirements on capital and going concern.

Each suggested practice in this guide is supplemented by examples of questions and discussions points that the supervisors should consider when meeting and interviewing banks and their auditors.

⁴ International Organization of Securities Commissions (IOSCO) maintains an IFRS database of its members' IFRS regulatory rulings.

⁵ Johannesburg Stock Exchange (JSE) publishes annually the results of its proactive monitoring of the IFRS financial statements of entities listed on the JSE.



SUGGESTED PRACTICES FOR SUPERVISORS TO APPLY

SUGGESTED PRACTICE 1

UNDERSTAND THE ECONOMIC AND BUSINESS ENVIRONMENT THE BANK OPERATES IN.

To identify potential significant areas for possible regulatory focus supervisors should understand and familiarise themselves with relevant economic cycles and events, relevant changing technologies, relevant market prices and relevant laws. Understanding the 'big picture' and key drivers of risks is crucial before focusing on the details.

Moreover, general conditions of the banking sector can provide an indication of the key risks faced by the bank and how these risks relate to the overall market conditions. Consequently, it is important for supervisors to understand the connections and linkages between the various sources of risks linked to the business and banking environment: business, financial, accounting and regulatory risks.

ENVIRONMENTS: ECONOMIC CYCLES; TECHNOLOGY; PRICES; AND LEGAL

Understanding the economic environments to which the regulated bank is exposed can indicate significant areas for possible regulatory focus. To do so effectively requires an understanding of, for example:

- the economic cycles (global/regional/domestic/local/other jurisdiction) to which the bank has significant exposure;

- the likely effect on the bank's operations, assets and liabilities of current economic conditions and of changes in relevant economic cycles;
- the likely effect on the bank of advances in relevant technologies; and
- the likely effect on the bank of changes in market prices.

Understanding the likely impact of the current economic cycle on the bank can be helpful in indicating areas for regulatory focus. Because business is increasingly geographically interconnected, consideration should be given to identifying the economic cycles of all jurisdictions that are likely to impact significantly the bank.

- Paying particular attention to geographic and sectoral concentrations of credit risk, which economies' economic cycles are significant to the bank (local, domestic, regional, other jurisdiction, international)?

The effect of the same economic conditions on different entities, even within the same sector, can be very different. Consequently, anticipating the likely impacts on the bank requires an understanding of the economic environments and conditions to which the bank's operations, resources and claims are exposed and the likely sensitivities of such exposures.

- What is the current state of the relevant economic environments and how have they changed in the reporting period?
 - Relevant to judgements about, for example:
 - determining functional currency (and change therein)
 - identifying impaired assets and testing them for impairment
 - measuring fair value (especially inputs at Level 3)
- Economic recession suggests increased regulatory focus on asset impairment judgements and going concern assessments.
 - However, impacts need not be industry wide. For example, in an economic recession, banks that lend mainly to budget retailers might experience reduced credit risk as those retailers' business boom and conversely for exposures to higher-end retailers as their businesses might contract.

- Economic boom might suggest increased regulatory focus on over-the-market optimistic assumptions in, for example: business combinations; asset valuations; and the reversal of prior period impairments.
 - However, focus on under-the-market assumptions is also useful in detecting earnings management, so called 'cookie jar accounting'.
- Joining or leaving a common market (and the related uncertainties) can have profound consequences for the scope of particular operations, competitiveness of others and wider implications for the forward-looking information effects when measuring expected credit losses.

CHANGING TECHNOLOGIES

Changing technology: the lifeblood of one business and the death knell of another.

Understanding the impact on the bank of the current, imminent and likely future changes in technology can be helpful in indicating areas for regulatory focus. **To do so effectively requires identifying significant changing technologies** that are relevant to the bank's operations and resources. Such changes can be fundamental to the bank when the bank leads the development of, or faces, disruptive technological change.

- Banks struggling to adapt to technology changes suggests regulatory focus on, for example, judgements in: recognising and measuring variable consideration; asset impairment testing; going concern assessments; and business combinations.
 - What are the current disruptive technological changes and who do they affect and how? Financial sector examples include:
 - The emergence of mobile-phone-based retail banking has revolutionised the accessibility of banking services in the developing world (for example, M-Pesa provides secure branchless banking services using mobile telephone technology and the pre-existing networks of airtime agents).
 - The emergence of blockchain technologies that enable, for example, cryptocurrencies.
 - Disruptive technologies outside of the financial sector are also relevant to banks because, for example, of their implications for assessing counterparty credit risk.

CHANGING MARKET PRICES

Understanding which market prices the bank is exposed to and anticipating the impact on the bank of changes in those market prices can be helpful in indicating areas for regulatory focus. Changes in which market prices (for example, particular interest rates, particular currency exchange rates and particular commodity prices) are likely most relevant to the bank?

- What are the bank's market risk exposures?⁶
- How does it manage its market risk exposures? A bank's price risk management activities might also indicate areas of regulatory focus (for example, compliance with rules specified for hedge accounting).

EXAMPLE 1: understanding a bank's exposure to market interest rate movements and how it manages interest rate risk provides regulatory focus.

- A bank's fixed-rate borrowing and fixed-rate lending activities create exposure to interest rate price risk. Banks with significant exposure to interest rate price risk typically follow a documented policy for managing that risk. The comprehensive principle-based interest rate price risk disclosures specified in IFRS 7 *Financial Instruments: Disclosures* likely are an important area of focus for the review of a bank's financial statements. Consequently, to review a bank's financial statements the reviewer must first understand:
 - the interest rates (for example, jurisdictional specific interest rates, LIBOR etc) to which the bank has material interest rate price risk exposure;
 - how the bank manages its material interest rate price risk exposures;
 - movements in the relevant interest rates in the period under review.

EXAMPLE 2: understanding a bank's exposure to foreign currency exchange rate movements and how it manages such risk provides regulatory focus.

- A bank's foreign currency denominated borrowing activities and its foreign currency denominated lending activities create exposure to currency price risk. Banks with significant exposure to currency rate

price risk typically follow a documented policy for managing that risk. The comprehensive principle-based currency price risk disclosures specified in IFRS 7 likely are an important area of focus for the review of a bank's financial statements. Consequently, to review a bank's financial statements the reviewer must first understand:

- the currencies to which the bank has material currency price risk exposure;
 - how the bank manages its material currency price risk exposures;
 - movements in the relevant currency exchange rates in the period under review.
- Lastly, as business becomes increasingly geographically integrated, the determination of some bank's functional currency requires significant judgement. Changes in circumstances can lead to a change of functional currency.

EXAMPLE 3: understanding a bank's exposure to commodity price movements and how it manages such risk provides regulatory focus.

- Some banks have material exposure to commodity price movements primarily through speculative derivative instruments with commodity price underlyings.
- Nearly all banks are exposed to credit risk implications that arise from the commodity price risk exposures of the bank's counterparties, as this affects the counterparties' abilities to repay their loans from the bank. Consequently, for example, the volatility of crude oil prices has implications for assessing counterparty credit risk of a wide range business and geographical sectors. Fossil fuel prices affect directly not only those that extract fossil fuels but also:
 - the producers of substitute end products, like palm oil, soya oil and natural latex; and
 - the consumers of refined petroleum products (for example, airlines) and substitute end-products.
 - However, airlines that manage their exposure to (or put another way, speculate in) jet fuel prices suffered losses when the oil price declined steeply and their 'unhedged' competitors lowered the retail price of flights.

⁶ In addition to using the information provided in the financial statements information concerning market risks provided by the Pillar 3 disclosures requirements can also be considered by regulators to determine areas of regulatory focus. An overview of the objectives and the information provided by Basel Pillar 3 market risk disclosures is provided in the Appendix.

CHANGING LAWS AND REGULATIONS

Understanding which laws and regulations the bank is exposed to, and anticipating the impact on the bank of changes in those laws, can be helpful in indicating areas for regulatory focus.

Identifying changes in laws and regulations that are relevant to a bank involves consideration of changes in the laws of the jurisdictions in which the bank operates. For example, the current Interbank Offer Rate (IBOR)⁷ reforms are expected to cause at least some IBORs to perform differently to the way they do currently or to disappear, which may impact banks' products and services⁸ and has implications for a bank's hedging activities. The International Accounting Standards Board (IASB) has proposed to amend IFRS 9 Financial Instruments and IAS 39 Financial Instruments: Recognition and Measurement to provide relief from specific hedge accounting requirements that could have resulted in the discontinuation of hedge accounting solely due to the uncertainty arising from interest rate benchmark reform.⁹

Furthermore, changes in the laws and regulations to which the bank's counterparties are subject can have significant implications for banks. For example, the measurement of a bank's expected credit losses would change if collateral it holds takes the form of the bank's right on default of the borrower to repossess:

- specified land use rights held by the borrower, and the land use right laws of that jurisdiction change such that the bank is prohibited from repossessing land-use rights.
- specified oil and gas exploration rights held by the borrower, and in response the geopolitical uncertainties the affected governments have suspended indefinitely the exploration for oil and gas in the disputed area.

Evidence of the significance of many banks' poor record of legal compliance is found in:

- the record breaking misconduct fines that have been imposed on many banks. For example, on 27/09/2017 Reuters (Hong Kong) reported:

"Regulators in the United States and Europe have imposed \$342 billion of fines on banks since 2009 for misconduct, including violation of anti-money laundering rules, and that is likely to top \$400 billion by 2020..."¹⁰

- some regulators, for example the Bank of England, including in their bank stress tests an independent stress test that includes otherwise unprovided for possible misconduct fines.

"the test will incorporate stressed projections for potential misconduct fines and other costs beyond those paid or provided for by the end of 2018. Banks are asked to provide stressed projections for misconduct costs that relate to known misconduct issues and have a low likelihood of being exceeded..."¹¹

Moreover, banks are exposed to credit risk implications that arise from changes in the law and misconduct fines that affect their counterparties' abilities to repay their loans from the bank. For example, the NOx emissions and other environmental debacles that have recently engulfed the motor vehicle manufacturing industry. For example:

"When notice of VW's fraud became public, the price of its bonds and ABS fell in secondary market trading. Major ratings agencies downgraded VW's bonds. VW did not conduct another bond or public ABS offering in the United States for over three years..."¹²

⁷ For example, the London Interbank Offered Rate (LIBOR), the Euro Interbank Offered Rate (EURIBOR), the Euro Overnight Index Average (EONIA) and others.

⁸ Source: <https://www.gbm.hsbc.com/financial-regulation/market-structure/ibor> (accessed on 04/06/2021)

⁹ Source: <https://www.ifrs.org/projects/work-plan/ibor-reform-and-the-effects-on-financial-reporting/comment-letters-projects/exposure-draft/> (accessed on 04/06/2019)

¹⁰ Source: <https://uk.reuters.com/article/us-banks-regulator-fines/u-s-eu-fines-on-banks-misconduct-to-top-400-billion-by-2020-report-idUKKCN1C210B>

¹¹ Source: Bank of England, March 2019, Stress testing the UK banking system: key elements of the 2019 annual cyclical scenario (see <https://www.bankofengland.co.uk/-/media/boe/files/stress-testing/2019/stress-testing-the-uk-banking-system-key-elements-of-the-2019-stress-test.pdf?la=en&hash=9F5CF1B969F5987CE2DBE1F1EA50D7ED5786AB4F>)

¹² Source: <https://www.sec.gov/litigation/complaints/2019/comp24422.pdf>

SUGGESTED PRACTICE 2

UNDERSTAND THE GROUP STRUCTURE, BUSINESS MODELS AND RISK PROFILE OF THE BANK.

Understanding the structure of a bank, and changes therein in the reporting period, is fundamental to ensuring that relevant economics is captured in the bank's financial statements. In some circumstances judgements must be made to determine the composition of the reporting entity and any changes therein attract regulatory focus. Such judgements include:

- Determining which entities are controlled by the bank, including special purpose entities, and therefore are part of the reporting entity (this consolidation principle is rooted deeply in the definition of an asset).
 - Such judgement includes determining when a subsidiary is first controlled by the bank and when it ceases to be controlled by the bank.
- Identifying business combinations. This includes determining whether the acquiree constitutes a business (a notion).¹³
- Identifying the acquirer in a business combination.
 - In a reverse acquisition, the legal acquirer is in economic substance (and for IFRS accounting) the acquiree.
- Applying the 'IAS 8 hierarchy' to develop an accounting policy for business combinations under common control involves assessments of:
 - Relevant information about such transactions (ie information that is capable of affecting primary users' resource allocation decisions made on the basis of that information) and whether such information can be faithfully represented etc. (principles rooted in the objective of general purpose financial information)

- Identifying IFRSs, if any, that specify accounting for a similar and related issue (a notion).
- If an entity chooses to seek guidance in the most recent pronouncements of other standard-setters:
 - which standards setters' conceptual frameworks are similar to the Conceptual Framework; and
 - whether the relevant requirements specified by others conflict with the Conceptual Framework or requirements of IFRSs dealing with similar and related issues.

Particular attention should be given to the existence of special purpose entities in the banking sector. An understanding should also be developed of the existence of unconsolidated structured entities, if any, and their associated risks.

Once supervisors understand the bank's structure they should familiarise themselves with the business models and risk profile of the bank as a whole. Accounting for financial assets in accordance with IFRS 9 is in part 'driven by' the business model in which the bank deploys the asset. Understanding the big picture and key drivers of risks is crucial before focusing on the details.

Because of variations between banks in terms of size, activities, business models and risk profiles, a one-size fits all approach or box-ticking approach to review and analyse financial statements is not appropriate.

A good understanding of the key drivers of revenue is also crucial to assess the big picture. Trading and non-trading activities impact the balance sheet.

The timing of recognition and derecognition might require judgement and can indicate key risks a bank faces and how these risks relate to the overall market conditions and the banking sector as a whole. Consequently, both auditors and supervisors need to consider and assess preparers' judgements.

Moreover, it is important for supervisors to understand the connections and linkages between the various sources of risks linked to the business and banking environment: business, financial, accounting and regulatory risks.

¹³ In October 2018 the IASB issued amendments to IFRS 3 Business Combinations that aim to clarify what is to be considered a business including an optional 'concentration test' that, if satisfied, eliminates the need for further assessment.

Bank specific areas that supervisors should understand include:

- Organisation (group) structure;
- Nature and scope of activities of the bank;
- Risk appetite of senior management and robustness of internal controls; and
- Management culture to drive the business.

SUGGESTED PRACTICE 3

IDENTIFY AREAS OF FOCUS: SIGNIFICANT BALANCE SHEET ITEMS (AND 'OFF-BALANCE SHEET' ITEMS), CRITICAL SOURCES OF INCOME AND KEY RISKS.

Supervisors should focus on key risks and material items after gaining an overall understanding of the bank's activities, risks and sources of income. Specific material areas of risks and sources of income are driven by the key business segments and business lines in which the bank operates. For example, a retail bank will have significant credit risk whereas an investment bank will have significant market risk.

Different banks focussing in different areas of the banking sector will have different business segments and will therefore face different types of risks. For example, a bank lending predominantly to SMEs would face different types of risks compared to a bank lending to large corporates.

Different business segments and different types of risks should be properly disclosed in the financial statements and the prudential returns. The disclosures should be granular and relevant.

Supervisors should review the disclosures and highlight the key business segments, key sources of income and related key risks faced by the bank. During the review, supervisors should first assess if the key risks disclosed in the financial statements are in line and consistent with their understanding of the business model and risk profiles of the bank.

Comparing risk disclosures in a bank's financial statements with the risk information in the bank's prudential returns can provide supervisors with a better understanding of key sources of profits and key drivers of risks.

Specific areas that supervisors should identify include:

- i. Different business segments and business lines;
- ii. Key income drivers;
- iii. Key risk drivers;
- iv. Interactions and consistency between key business lines and key risks; and
- v. Consistency of key risks identified in the financial statements and key risks listed in the prudential returns by the bank.

QUESTIONS AND DISCUSSIONS POINTS FOR SUPERVISORS TO CONSIDER WHEN REVIEWING FINANCIAL STATEMENTS, PRUDENTIAL RETURNS AND IN MEETINGS WITH PREPARERS AND AUDITORS

Significant items on balance sheet:

- What are the key items in the balance sheet of the bank?
- Are there significant 'off-balance sheet' exposures (for example, an unconsolidated special purpose vehicles (SPV), commitments to lend, other executory contracts and contingent liabilities)?
- Have the main judgements not involving measurement that management made in preparing the financial statements been identified and appropriately disclosed in a meaningful way?
- Have the key estimation uncertainties in the bank's financial statements been identified and appropriately disclosed in a meaningful way?
- Has the bank appropriately classified its financial instruments into IFRS 9's measurement categories: amortised cost, fair value through profit or loss, fair value through other comprehensive income ('debt instrument' asset) or fair value through other comprehensive income ('equity instrument' asset)?
- Has the bank disclosed the fair value of its financial instruments and investment property that is not carried at its fair value?

- Has the bank appropriately identified the level of the fair value hierarchy at which its items are measured, including its entity specific accounting policy for differentiating between the levels of the hierarchy?
- Has the bank appropriately applied IFRS 13 *Fair Value Measurement* in measuring the fair value including, using the appropriate measurement technique with appropriate assumptions?
- Has the bank appropriately impairment tested the assets it does not carry at fair value through profit or loss?

Key drivers of income:

- What are the key drivers of income for the bank?
- Which line of business is generating more income?
- Which line of business is generating less income?
- Which line of product is generating less income?
- Has there been a recent change in the most profitable line of business or products? If yes, why?
- Has there been a recent change in the least profitable or loss making line of business or products? If yes, why?
- Has the bank properly accounted for its income and expenses?

SUGGESTED PRACTICE 4

UNDERSTAND THE RELEVANT ACCOUNTING: CLASSIFICATION, RECOGNITION (AND DERECOGNITION), MEASUREMENT, PRESENTATION (AND DISCLOSURE).

When significant to the amounts recognised in its financial statements, disclosure in accordance with paragraph 122 of IAS 1 *Presentation of Financial Statements*, is required of judgements that do not relate to estimation uncertainty.

For example, paragraph 122 could apply to judgements in determining which IFRS applies to an item and which subclassification within a standard applies to an item.

ILLUSTRATION 1: CLASSIFICATION OF CLAIMS—LIABILITY OR EQUITY

Claims against a bank's assets are classified as either liability or equity. In essence, a liability is a present obligation of the bank and equity is the residual after deducting the bank's liabilities from its assets. Some financial instruments issued by a bank can be complex and the accounting does not always reflect the economics and can be different from the prudential rules. Judgement is needed in applying the principles and rules specified in IAS 32 *Financial Instruments: Presentation* to classify complex financial instruments issued by a bank. Examples of rules that override the classification principles in specified circumstances include:

- the other than 'fixed for fixed' rule (for example, a fixed obligation to be settled in variable number of entity's own shares) specified in IAS 32; and
- paragraph B4.3.5(e) of IFRS 9, which must be applied to the instrument before applying IAS 32, results in the asset component from issuing a complex financial instrument (that arises from a qualifying issuer-held early prepayment option) being offset against the liability component rather than being accounted for as a separate asset.

Particular IFRSs specify accounting and reporting for particular liabilities. Judgement is sometimes needed to determine which IFRS applies to a particular present obligation of the bank and which prudential rules are relevant to a particular financial instrument. Similarly, for income recognition judgement is needed in determining whether IFRS 9 or IFRS 15 *Revenue from Contracts with Customers* applies to some contracts (or components of particular contracts) commonly encountered by banks. For example, some customer loyalty schemes. Moreover, a change in the use to which an item is put or a change in the business model under which an item is managed can result in the reclassification of items.

In addition to the classification judgements set out above, a bank must make further judgements when presenting financial information. Examples include judgements about:

ILLUSTRATION 2: CHANGES IN THE CLASSIFICATION OF ASSETS

A change in the classification of an asset attracts regulatory focus when judgement is needed to determine the accounting that applies to the change, for example:

- determining when, in accordance with IFRS 9, a business model change is sufficiently clearly demonstrable to change the classification of a financial asset.
- determining when, in accordance with IFRS 13, a market is no longer sufficiently active to support classification at Level 1 of the fair value measurement hierarchy.
- determining when, in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, the criteria are first satisfied for classifying an owner-occupied property as a non-current asset held for sale (i.e. from, for example, IAS 16 *Property, Plant and Equipment* to IFRS 5).
- determining when the ancillary services provided by a bank to its tenants becomes significant, thus changing the classification of a property from investment property to property, plant and equipment (i.e. from IAS 40 *Investment Property* to IAS 16).
- materiality, when determining the level of aggregation/disaggregation in its financial information;
- relevance of alternative presentations, when considering voluntarily changing a presentation accounting policy;
- whether the requirements for offsetting (when required or permitted) are satisfied; and
- the extent to which a change in the fair value of a financial liability is attributable to the change

in the bank's own credit risk and consequently is presented in other comprehensive income.

MEASUREMENT

IFRS specifies different types of measurements, the application of which require very different judgements and estimates. **Banks are required to disclose major sources of estimation uncertainty. (paragraph 125 of IAS 1).**

Fair value measurement has a clear measurement objective—estimate the price at which an orderly transaction to sell an asset or to transfer a liability would take place between market participants at the measurement date under current market conditions. Therefore, the judgements in applying the fair value principle, are mainly—has the bank:

- identified the appropriate level of the fair value hierarchy?
 - If a bank uses Level 1, is there an identical item? And is the market in which that identical item trades an active market?¹⁴
 - If a bank uses Level 2, have no significant unobservable inputs been used? And does the bank specify its policy for identifying fair value measurements that have no significant unobservable inputs?¹⁵
 - Are other banks using the same level for the identical or similar items?
- used an appropriate model?¹⁶
 - Does the model maximise the use of observable inputs?
 - Are other banks using the same model for identical or similar items?
- used appropriate inputs?
 - Are changes in the inputs compared with prior years consistent with your understanding of the changes in economics over that time period?

¹⁴ Regulatory action example—JSE proactive monitoring (2016): in nearly all instances, debt issuers, inappropriately classified their own debt instruments as being within the Level 1 hierarchy because the market in which the quoted price is observed is not an 'active market' given the inactivity of trade in listed notes on the South African interest rate market. Even when trade does occur, it is not usually of sufficient frequency and volume to meet a Level 1 classification. At best, corporate debt in South Africa is likely to be a Level 2 classification, and perhaps even a Level 3. Similarly, a special purpose vehicle that issued mortgage bond securities had incorrectly classified their debt instruments as a Level 1 fair value.

¹⁵ Regulatory action example—JSE proactive monitoring (2016): (i) issuer owned investment property was incorrectly classified this as Level 2 because it is highly unlikely that property in the South African market will meet the criteria for a level 2 fair value classification; and (ii) operational financial instruments such as trade receivables and trade payables, finance leases, loans receivable and loans payable were incorrectly classified at Level 2 fair values.

¹⁶ Regulatory action example—UK FRC required AngloEastern Plantations plc to restate its financial statements twice for the 2010 Level 3 measurement of particular non-financial assets.

□ Are other banks using the same inputs for identical or similar items?

- taken account of all factors market participants would consider in measuring fair value?
- identified the few rules specified in IFRS 13 that override the fair value measurement principle; and has the bank applied those rules as specified in IFRS 13.

DERECOGNITION

In addition to the above issues, because IAS 39/IFRS 9 specify derecognition criteria that are different from the principle specified for first recognising a financial instrument, derecognition is not always the mirror image of recognition. Consequently, such derecognition criteria are necessarily a collection of broadly stated requirements or specific rules, or both (rather than principles), some of which require considerable judgement to apply.

ILLUSTRATION 3: CONTRASTING RECOGNITION WITH DERECOGNITION

Diagram: Derecognition rules for financial assets¹⁷



	Recognition	Derecognition
IFRS 9 <i>Financial Instruments</i>	<p>When the bank becomes party to the contractual provisions of the instrument (paragraph 3.1.1).</p> <p>Paragraph 3.1.2 introduces an optional rule.</p>	<p>For financial assets refer to paragraphs 3.2.1 to 3.2.23 and B3.2.1 to B3.2.17 (as summarised in the diagram above).</p> <p>For financial liabilities refer to paragraphs 3.3.1 to 3.3.4 and B3.3.1 to B3.3.7.</p>

¹⁷ based mainly on the flow chart in paragraph B3.2.1 of IFRS 9 *Financial Instruments*

THE DISCLOSURE PROBLEM

The IASB's takeaways from its January 2013 public discussion forum on financial reporting disclosure identifies the financial statement disclosure problem as having three main components:

1. not enough relevant information;
2. too much irrelevant information; and
3. ineffective communication of information.

A bank must make many judgements when making disclosures in its IFRS financial information. Particularly, when making disclosures that give effect to the disclosure objectives that are more frequently specified in new IFRSs. Moreover, IFRS is explicit that an entity need not disclose immaterial information (paragraph 31 of IAS 1) and must not obscure material information with immaterial information (paragraph 30A).

It is widely acknowledged that the root of the disclosure problem is behavioural.

Banks seem to believe that making all specified disclosures avoids justifying 'omitting' disclosures to auditors and historically this behaviour has not attracted regulatory challenge. This behaviour is exacerbated by inappropriate use of comprehensive 'Big4' disclosure checklists and an aversion to making materiality judgements coupled with the failure to consider whether the disclosure of immaterial information obscures material information. Many banks also present boilerplate disclosures rather than disclosing meaningful entity specific information. This behaviour is exacerbated by inappropriate use of all encompassing 'Big4' illustrative financial statements.

Nevertheless, the IASB has a number of active projects in the 'better communication' theme¹⁸ and some regulators are dedicating significant resources to projects addressing disclosure practices. For example, the UK Financial Reporting Council (FRC) clutter cutting initiatives¹⁹ aim to ensure amongst other things that 'Important messages, policies and transactions are highlighted and

supported with relevant context and are not obscured by immaterial detail. Cross-referencing and signposting is used effectively; repetition is avoided'.²⁰ Regulators are also increasingly challenging registrants' disclosure judgements (or the perceived lack thereof). For example: JSE proactive monitoring in 2017:

- Regarding accounting policies: the most frequent non-compliance identified is superfluous accounting policies (21 of 26 in 2016 and 5 of 6 in 2017).
- Regarding disclosures about the adoption of new Standards: our findings generally pointed to disclosure that was neither entity specific, nor did it provide sufficient detail that would enable a user to make an adequate assessment of the possible impact thereof to the issuer's financial statements.

SUGGESTED PRACTICE 5

REVIEW THE KEY ACCOUNTING POLICIES, ASSUMPTIONS AND INPUTS USED BY SENIOR MANAGEMENT.

The supervisors should understand and be able to question the selection of key accounting policies by senior management for each significant item on the balance sheet, critical areas of sources of income, and key risks.

Accounting policies should be consistent with the business models and risk profile of the bank. The supervisors should not audit or duplicate the work of auditors in these areas. Instead supervisors should keep a critical eye on the decisions taken by senior management and work performed by auditors to audit these areas. The supervisors should also be able to question and engage in a critical and constructive manner with the external auditors.

¹⁸ Disclosure Initiative project, Primary Financial Statements project and the IFRS (XBRL) Taxonomy project.

¹⁹ See <https://www.frc.org.uk/getattachment/8250571d-4c6d-4d0a-9aa6-ef6a19c1fab2/Cutting-clutter-report-April-20112.pdf>

²⁰ See <https://www.frc.org.uk/getattachment/311af48c-bdfa-4484-8e7d-6de689fd8f4b/Annual-Review-of-Corporate-Reporting-2016-17.PDF>.

Significant accounting policies may include policies used for the: valuations of loan loss provisioning, classifications of assets and liabilities, classifications of financial instruments, valuations of complex financial instruments, recognition of revenue and expense including the calculations of the effective interest rates, consolidation of SPVs and their related risks.

Supervisors should not only obtain a good understanding of these areas but also understand how senior management identifies transactions, events and conditions that give rise to accounting estimates and where senior management will need to use assumptions and apply judgements.

In addition, supervisors should understand how senior management make the accounting estimates, use the assumptions and apply the judgements and which sets of data and information they are using.

Specific areas that supervisors should obtain a good understanding are:

- i. Key accounting policies used by senior management for revenue recognition;
- ii. Key assumptions made by senior management to value assets and liabilities;
- iii. Key accounting estimates including expected credit loss provisioning and fair value estimates and related disclosures;
- iv. Sets of data and information used by senior management to value the accounting estimates; and
- v. Possible ranges of accounting estimates based on different assumptions used by senior management.

QUESTIONS AND DISCUSSIONS POINTS FOR SUPERVISORS TO CONSIDER WHEN REVIEWING FINANCIAL STATEMENTS, PRUDENTIAL RETURNS AND IN MEETINGS WITH PREPARERS AND AUDITORS

Measurement of key balance sheet items and financial performance items:

- Has the bank used the appropriate assumptions and estimates to value the assets and liabilities?
- Have the assumptions and estimates been reviewed and assessed by independent third parties e.g. external auditors, land and building surveyors, etc.

- Has the bank performed comprehensive impairment testing on relevant assets by using the latest available market information and estimates?
- Were the impairment tests reviewed and audited by the internal and external auditors?
- What did the internal auditors and external auditors highlighted in their audit files regarding valuations of assets and impairment testing?
- When using estimates to value assets and impairment testing, did the bank consider the range of possible values and their impact on the balance sheet and in profit or loss and other comprehensive income?
- Were the audit committee and the board fully aware of the range of possible values and their impact on the balance sheet and in profit or loss and other comprehensive income?
- What are the methodologies and assumptions used by management to classify liability and equity instruments?
- What are the methodologies and assumptions used by management when there are changes in the use of an asset?

SUGGESTED PRACTICE 6

QUESTION THE RELEVANCE AND APPROPRIATENESS OF THE DATA AND ASSUMPTIONS USED BY SENIOR MANAGEMENT.

Supervisors should be able to understand and question whether the key accounting policies, assumptions and accounting estimates are reasonable and in line with accounting standards and prudential requirements.

Supervisors should also be able to understand and question the going concern assumptions and disclosures used by management and auditors in the financial statements and in the audit report.

For example, accounting estimates are made when measuring expected credit losses and fair value when quoted market prices are not available for financial instruments. Senior management should use relevant and appropriate model inputs for these calculations that may lead to a range of possible outcomes and valuations.

Supervisors should understand the effective interest rate method and question the appropriateness of inputs where estimates are used in effective interest rate calculations. Senior management should use contractual cash terms of the instrument and reliable estimates of those cash flows.

In the areas of valuation, supervisors should understand the models, inputs and assumptions used and assess whether they are relevant, consistent and in line with accounting and regulatory requirements.

Other possible ways to assess these estimates and inputs are by reviewing and comparing:

- i. Accounting methodology versus regulatory methodology;
- ii. Accounting practices versus regulatory practices;
- iii. Financial statements and regulatory disclosures;
- iv. Market trends;
- v. Industry benchmark, practices and knowledge; and
- vi. Point estimates used with long run average or industry average.

When reviewing and comparing accounting with regulatory practices and disclosures, the supervisors assessment should, for example, cover the following areas:

- i. Whether disclosures are meaningful and relevant and provide users of financial statements sufficient information to understand the estimates and inputs used;
- ii. Critical accounting estimates used;
- iii. IFRS 7 credit risks disclosures on impairment; and
- iv. Whether management is consistently neutral (neither aggressive nor conservative) when using assumptions and estimates;

Accounting requirements may differ from regulatory requirements. These differences may be due to a number of reasons, such as:

QUESTIONS AND DISCUSSIONS POINTS FOR SUPERVISORS TO CONSIDER WHEN REVIEWING FINANCIAL STATEMENTS, PRUDENTIAL RETURNS AND IN MEETINGS WITH PREPARERS AND AUDITORS

Use of judgements and estimates and assumptions and linkages between accounting and prudential data:

- Are the estimates and assumptions used consistent with industry practices and benchmarks?
- Do the IFRS requirements for recognition and valuation of significant items differ from the regulatory requirements?
- Are there any prudential adjustments or prudential filters?
- Has senior management, the audit committee and the board understood clearly the impact and implications of the different requirements between IFRS and the regulatory framework?
- Did the bank explain clearly in the financial statements the impact of key accounting requirements on regulatory capital?
- Did the bank provide clear and meaningful disclosures reconciling the IFRS treatment and regulatory requirements?

SUGGESTED PRACTICE 7

ASSESS THE IMPACT OF KEY ACCOUNTING REQUIREMENTS ON CAPITAL AND GOING CONCERN.

There are a number of accounting requirements and treatments that could have significant impact on the capital of a bank and the going concern status of the institution.

One example is the assessment of credit risk and impairment of loans which can have severe impact on capital and going concern status of a bank in specific circumstances. The links between credit risk assessment, loan impairment and the timing of its impact on capital should be properly understood and monitored by the supervisors.

Financial statements disclosures and regulatory reporting provides some indications on credit risk assessment processes, loan impairment calculations and impact on capital.

Supervisors should focus on this information to obtain an understanding of the links and soundness of the bank.

When reviewing and comparing accounting with regulatory practices and disclosures, the supervisors assessment should, for example, cover the following areas:

- i. Credit risk assessment and mitigation techniques;
- ii. Assumptions and inputs used to determine cash flows, effective interest rate, valuations of collateral for the calculations of loan impairment;
- iii. Adequacy and impact of loan impairment on capital and going concern status;
- iv. Adequacy and impact of valuations of significant portfolio of financial instruments on capital and going concern; and
- v. Did the bank appropriately consider all post-balance sheet events and make the appropriate adjustments and disclosures (including going concern assessment effects)?

QUESTIONS AND DISCUSSIONS POINTS FOR SUPERVISORS TO CONSIDER WHEN REVIEWING FINANCIAL STATEMENTS, PRUDENTIAL RETURNS AND IN MEETINGS WITH PREPARERS AND AUDITORS

Credit risk assessment:

- Has the audit committee and the board fully discussed and understood the impact of impairment on the going concern of the bank and the impact on regulatory capital?

- Is the impairment testing of loans sufficient and adequate?
- What is the impact of loan impairment on profitability and capital requirements?
- Did auditors consider the impact on going concern and regulatory capital?

Post-balance sheet events:

- Are there any post balance sheet events?
- Are the post-balance sheet events affecting the going concern determination?
- Have the auditors examined and documented the post-balance sheet events?

ILLUSTRATION 4: POST-BALANCE SHEET EVENTS

Events after the reporting period (but before the financial statements are authorised for issue) attract regulatory focus when they are significant to the bank. Applying the principles specified in IAS 10 *Events After the Reporting Period* requires judgement to determine whether such an event is:

- a basis of preparation event (judgement: no longer a going concern);
- an adjusting event (judgement: material information about a condition that existed at the end of the reporting period);
- a non-adjusting (disclosure only) event (judgement: material information about a condition that did not exist at the end of the reporting period); or
- an ignorable event (judgement: immaterial).



KEY ACCOUNTING AND AUDITING ITEMS WHEN REVIEWING FINANCIAL STATEMENTS

This section provides examples of key accounting and auditing issues for supervisors to consider when reviewing financial statements.

IAS 1

1.

Key Financial
Statements items,
relevant IFRS standards
or audit report

Areas of focus relevant
to supervisors
or questions for
supervisors to consider

- Management's assessment of the bank's ability to continue as a going concern.
- If management concludes that the bank is a going concern but there are material uncertainties, what are the material going concern uncertainties and what are the expectations about their resolution?
- Adequacy of management's going concern assessment.
- Adequacy of going concern disclosures, particularly when there are significant going concern uncertainties.

Why is it important to supervisors?

The going concern determination is essentially management's assessment of whether the bank has realistic alternatives to liquidation in the foreseeable future.

Risks to supervisory objectives

Information provided by management about uncertainties about the bank's ability to continue as a going concern likely indicates impending stress or shocks to the balance sheet.

Actions for supervisors to consider²¹

2.

Key Financial Statements items, relevant IFRS standards or audit report

Areas of focus relevant to supervisors or questions for supervisors to consider

- Summary of significant accounting policies, most sensitive judgements that management has made in the process of applying the entity's accounting policies and key sources of estimation uncertainty that have the most significant effect on the amounts recognised in the financial statements.
- Information is revealed about management's most sensitive judgements and key sources of estimation uncertainty at the end of the reporting period, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year.
- Uncluttered financial statements ergonomically reveal decision useful information.
- Has the bank disclosed its material accounting policies in an entity specific meaningful (not boilerplate) way?
- Has the bank properly disclosed changes in its accounting policies from last year? Are those changes inappropriately concealing the correction of any prior period errors?
- Has management appropriately identified and disclosed the most sensitive judgements that it made in applying its accounting policies that have the most significant effect on the amounts recognised in the financial statements?
- Has management appropriately identified and disclosed the key measurement assumptions that it made in making the necessary estimates when preparing the bank's financial statements, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year?
- Has management cluttered the bank's financial statements (ie potentially obscured important information by drowning it out with immaterial information? And has information that is material to understanding the financial statements been inappropriately omitted from the financial statements?
- Has management appropriately identified and treated (adjusted/disclosed) significant events after the reporting period?

²¹ To be completed by reviewers of financial statements

Why is it important to supervisors?

Efficiently identifying material information and, in particular, management's most important judgements and most sensitive estimates enables understanding of the bank's financial position and performance and thus facilitates effective regulation.

The bank's disclosures provide complementary information to supervisors.

Risks to supervisory objectives

Inappropriate estimates, judgements and accounting policies may misstate financial information. In particular, incorrect valuations of assets and liabilities could result in own funds not being properly reflected.

Actions for supervisors to consider

3.

Key Financial Statements items, relevant IFRS standards or audit report

Qualitative information about the entity's objectives, policies and processes for managing capital, including

- Description of capital it manages
- Nature of external capital requirements, if any
- How it is meeting its objectives
- Quantitative data about what the entity regards as capital changes from one period to another
- Whether the entity has complied with any external capital requirements and if it has not complied, the consequences of such non-compliance.

Areas of focus relevant to supervisors or questions for supervisors to consider

- How does the bank manage capital?
- Is the bank management of capital in line with the bank's business model?
- What are the capital requirements?
- Has the bank met the capital requirements during the year? Were there any breaches of capital requirements.

Why is it important to supervisors?

The bank's policy in managing capital should be consistent with their current, future business plans and economic valuations.

The bank's risk profile and risk appetite may not be aligned with the way it manages capital.

Risks to supervisory objectives

Capital management is key to the regulatory and supervisory objectives.

Capital breaches or insufficient capital because of business models are key information for prompt and timely supervisory actions.

Actions for supervisors to consider

IFRS 13 - FAIR VALUE MEASUREMENT

1.

Key Financial Statements items, relevant IFRS standards or audit report

- Material financial assets and financial liabilities that are measured at fair value and the extent to which changes in fair value are presented in profit or loss and other comprehensive income.
- Material non-financial assets and non-financial liabilities that are measured at fair value and the accounting model used, for example, fair value model or revaluation model.
- Disclosures about the level of the fair value hierarchy at which fair value was measured.
- Expanded disclosures about Level 3 fair value measurements.
- Disclosures about the fair value of financial instruments and investment properties that are not carried at fair value.
- Disclosures about the impairment to recoverable amount (i.e. higher of fair value less costs of disposal and value in use) of non-financial assets.

Areas of focus relevant to supervisors or questions for supervisors to consider

- Is the bank using the appropriate model/s to measure fair value?
- Is the bank using appropriate model inputs when measuring fair value?
- How does the bank consistently draw the lines between the levels of the fair value hierarchy? And are its policies for doing so consistent with IFRS 13?
- Are the bank's fair value measurement disclosures, particularly at Level 3, adequate?

Why is it important to supervisors?

Inappropriately measuring fair value or inappropriately classifying the level of fair value measurements or omitting required disclosures could have a material effect on the financial statements.

Risks to supervisory objectives

If fair value measurement is not performed in compliance with IFRS 13 there is risk that the balance sheet is overstated or the purported quality of the assets is misleading. On the other hand, under-the-market assumptions could be being used to manage earnings, ie so called 'cookie jar accounting'. Non-compliance with IFRS 13 could negatively impact own funds.

Actions for supervisors to consider

IFRS 7 - CREDIT RISK

1.

Key Financial Statements items, relevant IFRS standards or audit report

Areas of focus relevant to supervisors or questions for supervisors to consider

Why is it important to supervisors?

Risks to supervisory objectives

Actions for supervisors to consider

- Management's objectives, policies, and processes for managing those risks

- How does the bank assess and mitigate credit risk?
 - Are the bank's credit risk disclosures informative?
 - Is the bank's loan loss provision adequate?

Is the credit risk assessment adequate or appropriate for the risk profile of the bank?

If the credit risk management is not appropriate or adequate there could be potential future losses and impairment that would eventually negatively impact own funds.

2.

Key Financial Statements items, relevant IFRS standards or audit report

Areas of focus relevant to supervisors or questions for supervisors to consider

- Maximum amount of exposure including loan commitments and financial guarantees (and before deducting the value of collateral), description of collateral, information about credit quality of financial assets that are neither past due nor impaired, and information about credit quality of financial assets whose terms have been renegotiated.
- For financial assets that are past due or impaired, analytical disclosures are required.
- Information about collateral or other credit enhancements obtained or called.
- Nature and valuation of collateral available and breakdown of past due loans. Changes compared with last year.
- Nature and types of loans (sector, counterparty, etc.) that are impaired.

Why is it important to supervisors?

Information about quality and valuation of collateral provide supervisors more information about the credit risk of the bank.

Increase in impaired loans in specific sectors or types of counterparties can inform supervisors about emerging credit risks.

Risks to supervisory objectives

If clear and detailed information of past due and impaired loans are not provided, up to date information about adequacy of own funds may be lacking.

Actions for supervisors to consider

IAS 39 (IF APPLICABLE)

1.

Key Financial Statements items, relevant IFRS standards or audit report

An entity is required to assess at each balance sheet date whether there is any objective evidence of impairment. If any such evidence exists, the entity is required to do a detailed impairment calculation to determine whether an impairment loss should be recognised.

The amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated cash flows discounted at the financial asset's original effective interest rate.

Areas of focus relevant to supervisors or questions for supervisors to consider

- How frequent the bank assesses impairment?
- Who assesses the impairment?
- How is impairment calculated?

Why is it important to supervisors?

If the bank does not test for impairment regularly, then it may not identify impaired loans and assets on time.

Impaired assets and provisions could be underestimated.

Risks to supervisory objectives

Lack or irregular impairment testing could hide unrealised or realised losses which in turn would impact own funds negatively.

Actions for supervisors to consider

2.

Key Financial
Statements items,
relevant IFRS standards
or audit report

Assets that are individually assessed and for which no impairment exists are grouped with financial assets with similar credit risk statistics and collectively assessed for impairment.

Areas of focus relevant
to supervisors
or questions for
supervisors to consider

- How does individual impairment differs from collective impairment?

Why is it important to
supervisors?

The use of the wrong method of impairment could results in underestimating the amount of impairment.

Risks to supervisory
objectives

Misstating the correct amount of impairment will misstate the amount of own funds.

Actions for supervisors
to consider

TRANSITION FROM IAS 39 TO IFRS 9: IAS 8 DISCLOSURES (IF APPLICABLE)

1.

Key Financial
Statements items,
relevant IFRS standards
or audit report

- If bank is yet to apply IFRS 9, the disclosures about its preparations for and expected financial effects of transitioning to IFRS 9 (recall the detailed guidance issued by ESMA).
- If bank transitioned to IFRS 9, the presentation and disclosure of the effects of the changes in its accounting policies including information about its use of the available transitional provisions.

Areas of focus relevant
to supervisors
or questions for
supervisors to consider

Has the bank appropriate explained its transition to (or impending transition to) IFRS 9 in an entity-specific manner that is consistent with the requirements of IAS 8 and the regulatory guidance issued by ESMA and others.

Why is it important to supervisors?

IFRS 9 fundamentally changes accounting for the financial instruments (particularly, financial assets) that make up most of the bank's balance sheet.

Risks to supervisory objectives

Inadequate preparation for the transition to IFRS 9 risks poor implementation of IFRS 9. Deficient financial information about the bank's primary assets and liabilities could lead to the inadequate supervisory decisions and untimely regulatory actions.

Actions for supervisors to consider

IFRS 9 (IF APPLICABLE)

1.

Key Financial Statements items, relevant IFRS standards or audit report

- Classification of loans and other financial assets in measurement categories: i) FVPL; (ii) amortised cost; (iii) FVOCI 'debt instrument' (ie amortised cost in the income statement and fair value in the balance sheet); and iv) FVOCI 'equity instrument'.

Areas of focus relevant to supervisors or questions for supervisors to consider

- Has the bank used an appropriate methodology to classify the financial assets according to the requirements of IFRS 9?

Why is it important to supervisors?

An appropriate methodology will reflect the actual business model of the bank (rather than its intentions) and the cash flow characteristics of the instruments (and, if used, the optional deeming provisions).

Risks to supervisory objectives

Inaccurate information about the business models of the bank and the cash flow of the instrument could lead to the inadequate supervisory decisions and untimely regulatory actions.

Actions for supervisors to consider

2.

Key Financial Statements items, relevant IFRS standards or audit report

Areas of focus relevant to supervisors or questions for supervisors to consider

Why is it important to supervisors?

Risks to supervisory objectives

Actions for supervisors to consider

Credit risk assessment of loans and other assets in stages 1 performing loans, 2 underperforming loans and 3 nonperforming loans.

- Has the bank properly assessed the credit risk of financial assets in each stage? For example:
 - Is the bank's 'definition' of default appropriate?
 - Is the bank's policy for identifying significant increase in credit risk fit for purpose?
 - Is the bank's policy for identifying credit impaired financial assets appropriate?

Correct assessment of credit risk is a key factor for supervisory assessment.

Inappropriate assessment of credit risk would provide the supervisors misleading information about the risk profile of the bank.

3.

Key Financial Statements items, relevant IFRS standards or audit report

Areas of focus relevant to supervisors or questions for supervisors to consider

Why is it important to supervisors?

Risks to supervisory objectives

Actions for supervisors to consider

- Calculations of impairment of loans and other financial assets in stages 1, 2 and 3.

- Has the bank properly measured the loan loss provision of its financial assets in each stage?

Appropriate measurement will reflect accurately expected credit losses in accordance with IFRS 9.

Inappropriate measurement of expected credit losses will not provide a true reflection of the amount of unrealised or realised losses and their impact on capital.

IFRS 10/IFRS 12

1.

Key Financial Statements items, relevant IFRS standards or audit report

- Scope of consolidation

Areas of focus relevant to supervisors or questions for supervisors to consider

- Are all entities properly consolidated (pay special attention to control judgements and SPVs)?
- Are adequate disclosures provided explaining structured entities that are appropriately off-balance sheet?

Why is it important to supervisors?

The boundaries of the reporting entity must be determined so that the consolidated financial statements reflect all of the reporting bank with supplementary disclosures for unconsolidated structured entities.

Risks to supervisory objectives

Incomplete financial statements (for example, inappropriately excluding a SPV) would omit financial information and conceal financial risks.

Actions for supervisors to consider

IAS 32

1.

Key Financial Statements items, relevant IFRS standards or audit report

- The classification between debt (liability) and equity

Areas of focus relevant to supervisors or questions for supervisors to consider

Is the split between debt and equity in line with the IFRS requirements and the implications for regulatory requirements?

Why is it important to supervisors?

If the wrong IFRS treatment is applied, the implications for prudential capital could be misleading and hence will give a wrong capital position.

Risks to supervisory objectives

A wrong capital position could imply capital breaches.

Actions for supervisors to consider

IAS 40, IAS 16 AND IFRS 5

1.

Key Financial Statements items, relevant IFRS standards or audit report

- Properties used for investment and their valuation
- Properties used as owner occupied buildings
- Properties held for sale

Areas of focus relevant to supervisors or questions for supervisors to consider

- Are the properties valued at cost or market value?
- Is the market value based on latest and most relevant data and assumptions?
- Have the properties been tested for impairment?

Why is it important to supervisors?

If the wrong or outdated data and assumptions are used, the value of investment properties could be overestimated in the balance sheet.

Risks to supervisory objectives

Misstatement of the valuations of investment properties would hide potential losses.

Actions for supervisors to consider

AUDIT REPORT

1.

Key Financial Statements items, relevant IFRS standards or audit report

- Identification of key audit matters.

Areas of focus relevant to supervisors or questions for supervisors to consider

Auditors in the new audit report document and explain specific areas, such as risk assessment, impairment, capital management that they have identified during the audit which may need improvement.

Why is it important to supervisors?

Key audit matters are supposed to inform users of financial statements and supervisors about key risks and key issues faced by the bank.

They are a complementary source of information for supervisors.

Risks to supervisory objectives

Supervisors should be aware of the key audit matters highlighted by auditors in the audit report as they could identify emerging areas of risks building up in a bank.

Actions for supervisors to consider

2.

Key Financial Statements items, relevant IFRS standards or audit report

- Qualifications of the audit report, if any.

Areas of focus relevant to supervisors or questions for supervisors to consider

Auditors must qualify the audit report they have identified significant material misstatements or areas where they were unable to audit properly.

Why is it important to supervisors?

A qualified audit report (and to a lesser extent, an auditor's emphasis of matter) are supposed to inform users of financial statements and supervisors about key risks and key issues faced by the bank.

They are a complementary source of information for supervisors.

Risks to supervisory objectives

A qualified audit report could mean a number of things such as inadequacy of capital, key risks that the bank has ignored or material misstatements of assets and liabilities.

Actions for supervisors to consider



APPENDIX: IFRS 9 FINANCIAL INSTRUMENTS

This annex provides information that may be useful for supervisors of how banks should apply IFRS 9. It is designed to help supervisors gather and understand information prepared under IFRS 9 that may be relevant to its supervision.

It includes references to the standard and to interpretations of the Interpretation Committee (IFRIC) and guidance provided by the Basel Committee of Banking Supervision, applicable to banks in jurisdictions that are a signatory to the Basel Accord.

CLASSIFICATION AND MEASUREMENT UNDER IFRS 9

IFRS 9 aligns the classification and measurement of a financial asset for financial reporting with how the asset is managed and its contractual cash flows. IFRS 9 requires financial assets to be classified into one of three categories based on the business model used for managing such assets and the cash flow characteristic of the asset. Although the permissible measurement categories for financial assets appear to be like IAS 39, the criteria for classification into the appropriate measurement category are significantly different. IFRS 9 removed the previous categories of held-to-maturity, loans and receivables and available-for-sale. Also, IFRS 9 largely carries forward the scope of IAS 39. Financial assets in the scope of IAS 39 are also in the scope of IFRS 9.

CLASSIFICATION OF FINANCIAL ASSETS OTHER THAN EQUITY INSTRUMENTS

	Business model = hold to collect	Business model = hold to collect and sell	Other business models
Cash flows are solely payments of principal and interest (SPPI)	Amortised cost	FVOCI	FVPL
Other types of cash flows	FVPL	FVPL	FVPL

It should be noted that the above classification requirements do not apply for equity instruments as defined in IAS 32 ("An equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.").

CLASSIFICATION OF FINANCIAL ASSETS

Correct classification of financial assets plays a critical role in determining the level of credit risk of a financial institution. It is only financial assets classified and measured as at either amortised cost or Fair Value through Other Comprehensive Income (FVOCI) that are subject to the Expected Credit Losses (ECL) provisioning requirements. Amortised cost measurement determines the carrying amounts of such assets which are not only used for the purposes of determining ECL but also form the basis for assets values for prudential purposes.

Classification of financial assets presents a risk because of the inherent complexity of financial instruments and the application of an accounting policy that requires management judgement concerning determination of business models. In addition, although expected to be rare, reclassification of financial assets presents another area of risk as such reclassifications have the potential to change assets considered for provisioning purposes.

EXPECTED CREDIT LOSSES

Under the impairment approach in IFRS 9 it is no longer necessary for a credit event to have occurred before credit losses are recognized as it was before under the incurred loss model of IAS 39. Instead, an entity always accounts for expected credit losses, and changes in those expected credit losses.

Whilst the unit of account in IFRS 9 is the individual contract or loan, ECL estimates are often carried out based on portfolios of loans with similar credit risk characteristics for example credit card loans or mortgages in a particular geographic segment. The aggregation of individual loans into portfolios represents a key management decision in determining the adequacy and accuracy of any ECL estimate.

In a nutshell, IFRS 9 requires an entity to recognize 12 month ECL on all financial assets measured at amortized cost or FVOCI as long as the credit risk on the financial asset has not increased significantly since initial recognition and these are referred to as Stage 1 assets. For financial assets that have had a significant increase in credit risk since initial recognition, IFRS 9 requires the impairment provisions to be measured at lifetime ECL and these are Stage 2 assets.

EXPECTED CREDIT LOSSES: OVERVIEW OF GENERAL MODEL

	Change in credit risk since initial recognition		
	Stage 1 'Performing'	Stage 2 'Underperforming'	Stage 3 'Non performing'
Expected credit losses recognised	12-month expected credit losses	Lifetime expected credit losses	Lifetime expected credit losses
Interest revenue	Gross basis	Gross basis	Net basis

For both Stage 1 and Stage 2 assets interest revenue is recognized on a gross basis. In case of default, the financial asset is moved to Stage 3 and interest revenue for such assets is recognized on a net basis i.e. interest revenue is recognized on the amount net of provisions and not the gross carrying amount of the financial asset as for Stage 1 and Stage 2 assets.

The amount of expected credit losses is updated at each reporting date to reflect changes in credit risk since initial recognition and, consequently, more timely information is provided about expected credit losses.

Apart from purchased or originated credit, impaired financial assets ECL are required to be measured through a loss allowance at an amount equal to:

- 12-month ECL (ECL that results from default events on the financial instrument that are possible within 12 months after the reporting date); or
- lifetime ECL (ECL that result from all possible default events over the life of the financial instrument).

A loss allowance for lifetime ECL is required for a financial instrument if the credit risk on that financial instrument has increased significantly since initial recognition what is termed as a significant increase in credit risk since initial recognition or SICR. A significant increase in credit risk is defined as a significant increase in the probability of a default occurring since initial recognition.

IFRS 9 also requires that (other than for purchased or originated credit impaired financial instruments) if a significant increase in credit risk that had taken place since initial recognition, has reversed by a subsequent reporting period (i.e., at the reporting date credit risk has not significantly increased since initial recognition) then the loss allowance reverts to 12-month ECL.

For application of the model to a loan commitment, an entity must consider the risk of a default occurring under the loan to be advanced, whilst application of the model for financial guarantee contracts requires consideration of the risk of a default occurring on the specified debtor.

In addition to financial assets that are measured at amortized cost (including trade receivables) and at fair value through other comprehensive income, the ECL model also applies to the following:

- a. loan commitments and financial guarantee contracts for the issuer, that are not measured at fair value through profit or loss;
- b. lease receivables that are accounted for in accordance with IFRS 16 Leases; and
- c. contract assets that are recognized and measured in accordance with IFRS 15.

ECL ESTIMATE

The process for accounting for provisions has become more complex essentially because the accounting model has shifted from provisioning based on credit risk events that have already taken place to those that are expected to take place.

The ECL provision estimates often present a risk because they often have the following characteristics (as outlined by the Global Public Policy Committee²²):

- The accounting policy and related techniques to undertake the estimate are complex (i.e. and could be designed and/or applied erroneously),
- The estimation process involves significant management judgement (i.e. which is subject to bias), and
- Since the estimation process involves predicting future events, there is estimation uncertainty

Given the significance of such provisions from a prudential and financial stability perspective the section below outlines various steps that a supervisor can consider in their evaluation of the adequacy of such provisions in a bank's financial statements. The section below outlines recommendations that address both the computational elements of ECL along with the systems that a bank needs to implement in order to ensure the adequacy of such provisions on an ongoing basis.

MANAGEMENT PROCESSES

Management's process for performing the ECL estimate should contain the following key aspects:

- Selection of an accounting policy that complies with IFRS
- Establishment of an effective IT Environment within which the estimation is processed, including the systems covering data that is used as inputs to the estimate
- Establishment of controls to ensure complete and accurate data

- Development and maintenance of models
- Support for the significant judgements and assumptions that are used in the estimation process
- Assessment of whether disclosures regarding ECL are complete, clear and useful for financial statement users

Supervisors need to evaluate a bank's policy regarding ECL for the above aspects in order to evaluate the efficacy of the bank's credit risk management activities.

EVALUATION OF KEY INPUTS

ECL being an estimate of expected credit losses it is important for the supervisor to understand what inputs and assumptions made have the most significant impact on the estimate.

The sensitivity of the ECL estimate will depend on several factors for example the type of product, the level of collateral, geography, industry and macroeconomic variables to mention a few. For example, for certain mortgages the key factor could be the value of the property or loan to value ratios whilst for other types of retail lending it could be the level of unemployment in a sector or geography.

Consequently, the managements analysis of the above using for example sensitivity analysis of the estimates, should be evaluated when considering the adequacy of ECL provisions.

CONSISTENCY BETWEEN THE CREDIT RISK MANAGEMENT PROCESS AND THE PROCESS TO ESTIMATE THE ECL

IFRS 9 ECL provisions are based on management expectations of future credit losses. However, such expectations should be based on management estimates that are applied consistently across an organization. For example, growth forecasts used for the development for ECL estimates should be consistent with the forecasts used for business planning.

²² The Global Public Policy Committee (GPPC) comprises the six largest international accounting networks comprising of representatives from BDO, Deloitte, EY, Grant Thornton, KPMG and PwC, and focuses on public policy issues for the profession.

A bank's board of directors (or equivalent) and senior management are responsible for ensuring that the bank has appropriate credit risk practices, including an effective system of internal control, to consistently determine adequate allowances in accordance with the bank's stated policies and procedures, the applicable accounting framework and relevant supervisory guidance.

As per BCBS requirements on sound credit risk management, a bank needs to adopt, document and adhere to sound methodologies that address policies, procedures and controls for assessing and measuring credit risk on all lending exposures. The measurement of allowances should build upon those robust methodologies and result in the appropriate and timely recognition of expected credit losses in accordance with the applicable accounting framework.

A bank's aggregate amount of allowances, regardless of whether allowance components are determined on a collective or an individual basis, should be adequate and consistent with the objectives of the applicable accounting framework.

A bank's use of experienced credit judgment, especially in the robust consideration of reasonable and supportable forward-looking information, including macroeconomic factors, is essential to the assessment and measurement of expected credit losses.

A bank should have a sound credit risk assessment and measurement process that provides it with a strong basis for common systems, tools and data to assess credit risk and to account for expected credit losses.

A bank's public disclosures should promote transparency and comparability by providing timely, relevant and decision-useful information.

EFFECTIVE INTERNAL CONTROL SYSTEMS

An effective internal control system for credit risk assessment and measurement is essential to enabling senior management to carry out its duties. An effective internal control system should include:

- a. measures to comply with applicable laws, regulations, internal policies and procedures;
- b. measures to provide oversight of the integrity of information used and reasonably ensure that the allowances reflected in the bank's financial statements

and its supervisory reports are prepared in accordance with the applicable accounting framework and relevant supervisory guidance;

- c. well defined credit risk assessment and measurement processes that are independent from (while taking appropriate account of) the lending function, which contain:

- an effective credit risk rating system that is consistently applied, accurately grades differing credit risk characteristics, identifies changes in credit risk on a timely basis, and prompts appropriate action;
- an effective process which ensures that all relevant and reasonable and supportable information, including forward-looking information, is appropriately considered in assessing and measuring ECL. This includes maintaining appropriate reports, details of reviews performed, and identification and descriptions of the roles and responsibilities of the personnel involved;
- an assessment policy that ensures ECL measurement occurs not just at the individual lending exposure level but also when necessary to appropriately measure ECL at the collective portfolio level by grouping exposures based on identified shared credit risk characteristics;
- an effective model validation process to ensure that the credit risk assessment and measurement models can generate accurate, consistent and unbiased predictive estimates on an ongoing basis. This includes establishing policies and procedures which set out the accountability and reporting structure of the model validation process, internal standards for assessing and approving changes to the models, and reporting of the outcome of the model validation;
- clear formal communication and coordination among a bank's credit risk staff, financial reporting staff, senior management, the board and others who are involved in the credit risk assessment and measurement process for an ECL accounting framework, as applicable (eg evidenced by written policies and procedures, management reports and committee minutes); and
- an internal audit function that independently evaluates the effectiveness of the bank's credit risk assessment and measurement systems and processes, including the credit risk rating system.

A bank should adopt and adhere to written policies and procedures detailing the credit risk systems and controls used in its credit risk methodologies and the separate roles and responsibilities of the bank's board and senior management. Although this is not an all-inclusive list, robust and sound methodologies for assessing credit risk and measuring the level of allowances (subject to exposure type, eg retail or wholesale) generally will:

- a. include a robust process that is designed to equip the bank with the ability to know the level, nature and drivers of credit risk upon initial recognition of the lending exposure to ensure that subsequent changes in credit risk can be identified and quantified;
- b. include, for collectively evaluated exposures, a description of the basis for creating groups of portfolios of exposures with shared credit risk characteristics;
- c. identify and document the ECL assessment and measurement methods (such as a loss rate method, probability of default (PD)/loss-given-default (LGD) method, or another method) to be applied to each exposure or portfolio;
- d. document the reasons why the selected method is appropriate, especially if different ECL measurement methods are applied to different portfolios and types of individual exposures. A bank should be able to explain to its supervisors the rationale for any changes in measurement approach (e.g. a move from a loss rate method to a PD/LGD method) and the quantitative impacts of such changes;
- e. document the inputs, data and assumptions used in the allowance estimation process (such as historical loss rates, PD/LGD estimates and economic forecasts), how the life of an exposure or portfolio is determined (including how expected prepayments and defaults have been considered), the time period over which historical loss experience is evaluated, and any adjustments necessary for the estimation of ECL in accordance with the applicable accounting framework. For example, if current and forecasted economic conditions are different from those that existed during the historical estimation period being used, adjustments that are directionally consistent with those differences should be made. In addition, a bank may have experienced little to no actual losses in the historical period analyzed; however, current or forward-looking conditions can differ from conditions during the historical period, and the impact of these changes on ECL should be assessed and measured;
- f. include a process for evaluating the appropriateness of significant inputs and assumptions in the ECL assessment and measurement method chosen. It is expected that the basis for inputs and assumptions used in the estimation process will generally be consistent from period to period. Where inputs and assumptions change, the rationale should be documented;
- g. identify the situations that would generally lead to appropriate changes in ECL measurement methods, inputs or assumptions from period to period (eg the bank may state that a loan that had been previously evaluated on a collective basis using a PD/LGD method may be removed and evaluated individually using the discounted cash flow method upon receipt of new, borrower-specific information such as the loss of employment);
- h. consider the relevant internal and external factors that may affect ECL estimates, such as the underwriting standards applied to a lending exposure at origination and changes in industry, geographical, economic and political factors;
- i. address how ECL estimates are determined (e.g. historical loss rates or migration analysis as a starting point, adjusted for information on current and expected conditions). A bank should have an unbiased view of the uncertainty and risks in its lending activities when estimating ECL;
- j. identify what factors are considered when establishing appropriate historical time periods over which to evaluate historical loss experience. A bank should maintain enough historical loss data (ideally over at least one full credit cycle) to provide a meaningful analysis of its credit loss experience for use as a starting point when estimating the level of allowances on a collective or individual basis;
- k. determine the extent to which the value of collateral and other credit risk mitigants affects ECL;
- l. outline the bank's policies and procedures on write-offs and recoveries;
- m. require that analyses, estimates, reviews and other tasks/processes that are inputs to or outputs from the credit risk assessment and measurement process are performed by competent and well trained personnel and validated by personnel who are independent of the bank's lending activities. These inputs to and outputs from these functions must be well documented, and the documentation should include clear explanations supporting the analyses, estimates and reviews;

- n. document the methods used to validate models for ECL measurement (e.g. back-tests);
- o. ensure that ECL estimates appropriately incorporate forward-looking information, including macroeconomic factors, that has not already been factored into allowances measured on an individual exposure basis. This may require management to use its experienced credit judgment to consider broad trends in the entire lending portfolio, changes in the bank's business model, macroeconomic factors etc; and
- p. require a process to assess the overall adequacy of allowances in accordance with the relevant accounting requirements.

USE OF MODELS

In any approach used, be it PD (probability of default) or loss rate / flow rate model, the key is determining the expectations of a debtor not meeting their contractual obligation in the future i.e. a measure of the credit risk. In PD models, this is done by explicitly determining the probability of default as this measure of credit risk. This can be done in a number of ways – by converting credit ratings into probability of defaults or by computing the same using the banks own historical data. It should also be noted that the PD does not remain constant over the life of a loan but evolves as time passes. Consequently, the PD of a loan at inception can be very different from the PD of the same loan after say two years since initial recognition. One method of capturing this evolution is to use transition matrices. This is then combined with the LGD (Loss Given Default) to arrive at the ECL number under IFRS 9.

In a loss rate model this measure of credit risk is determined based on the value of the losses for a given portfolio. This measures the amount of the losses expected in a portfolio of similar loans and not the probability of that loan defaulting i.e. the PD. Since this measure already provides the amount of expected losses there is no separate need for determining LGD. This is comparatively simpler to apply and can be and is used based on facts and circumstances for example the absence of granular data on defaults by maturity or absence of systems to capture and compute the required PDs and LGDs.

EAD or Exposure At Default is simply determines the amount of the loan or asset that will be outstanding at future dates i.e. including interest accrual and loan

repayments in case of amortising loans. This determines the amount of exposure for the bank at different points in time in the future on which ECL is computed.

The above represent a brief stylised summary of the different models used for determining ECL and is not a comprehensive list. For the purposes of any supervisory review it is essential that all involved develop a clear understanding of the use of such models as outlined below.

Given the nature of ECL, models must be used to form a forward-looking estimate of expected credit losses. IFRS 9 in BC 5.242 states:

"The IASB decided to retain the emphasis on the objective of the measurement of expected credit losses, and to keep the requirements principle-based instead of specifying techniques to measure expected credit losses."

Consequently, IFRS 9 does not specify any methodology or model that needs to be used. In practice the types of models can be very broadly divided into two groups – PD/LGD models or models using loss rates or other forms of measures for capturing credit risk. The choice of model depends on several factors including type of asset, data availability, sophistication and availability of systems and resources for implementing models. Consequently, the choice of model or methodology for determining ECL is a key management decision, as any approach used must meet the objectives for the measurement of ECL as specified in IFRS 9. Consequently, a bank should have written policies and procedures concerning model choice with the underlying reasons for such a choice as outlined in the section on policies and controls on credit risk management and also have policies and procedures in place to appropriately validate models used to assess and measure expected credit losses.

ECL assessment and measurement may involve models and assumption-based estimates for risk identification and measurement. Models may be used in various aspects of the ECL assessment and measurement process at both the individual transaction and overall portfolio levels, including credit grading, credit risk identification, measurement of ECL allowances for accounting purposes, stress testing and capital allocation. ECL assessment and measurement models ("models") should consider the impact of changes to borrower and credit risk-related variables such as changes in PDs, LGDs, exposure amounts, collateral values, migration of

default probabilities and internal borrower credit risk grades based on historical, current and reasonable and supportable forward-looking information, including macroeconomic factors.

As the development and use of ECL assessment and measurement models involves extensive judgment, effective model validation policies and procedures are crucial. For these reasons it is reasonable to expect that banks have robust policies and procedures in place to validate the accuracy and consistency of its model-based rating systems and processes and the estimation of all relevant risk components, at the outset of model usage and on an ongoing basis. Model validation should be conducted when the ECL models are initially developed and when significant changes are made to the models. A bank should regularly (for example, annually) review its ECL models.

A sound model validation framework should include, but not be limited to, the following elements:

- a. Clear roles and responsibilities for model validation with adequate independence and competence. Model validation should be performed independently of the model development process and by staff with the necessary experience and expertise. Model validation involves ensuring that the models are suitable for their proposed usage, at the outset and on an ongoing basis. The findings and outcomes of model validation should be reported in a prompt and timely manner to the appropriate level of authority.
- b. An appropriate model validation scope and methodology include a systematic process of evaluating the model's robustness, consistency and accuracy as well as its continued relevance to the underlying portfolio. An effective model validation process should also enable potential limitations of a model to be identified and addressed on a timely basis. The scope for validation should include a review of model inputs, model design and model outputs/performance.
 - Model inputs – A internally established quality and reliability standards on data (historical, current and forward-looking information) used as model inputs needs to be in place. Data used to estimate ECL allowances should be relevant to the bank's portfolios, and as far as possible accurate, reliable and complete (i.e. without exclusions that could bias ECL estimates). Validation should ensure that the data used meet these standards.

- Model design – For model design, validation should demonstrate that the underlying theory of the model is conceptually sound, recognized and generally accepted for its intended purpose. From a forward-looking perspective, validation should also assess the extent to which the model, at the overall model and individual risk factor level, can take into consideration changes in the economic or credit environment, as well as changes to portfolio business profile or strategy, without significantly reducing model robustness.
- Model output/performance – It is recommended that a bank have internally established standards for acceptable model performance. Where performance thresholds are significantly breached, remedial actions to the extent of model re-calibration or re-development should be considered.

- c. Comprehensive documentation of the model validation framework and process. This includes documenting the validation procedures performed, any changes in validation methodology and tools, the range of data used, validation results and any remedial actions taken where necessary and also ensure the regular review and updating of such documents.
- d. A review of the model validation process by independent parties (e.g. internal or external parties) to evaluate the overall effectiveness of the model validation process and the independence of the model validation process from the development process. The findings of the review should be reported in a prompt and timely manner to the appropriate level of authority (e.g. senior management, audit committee).

OVERLAYS OR TEMPORARY ADJUSTMENTS

Temporary adjustments to the allowance are adjustments which may be used to account for circumstances when it becomes evident that existing or expected risk factors have not been considered in the credit risk rating and modelling process. It is expected that such adjustments would be used only as a temporary solution – for example, in transient circumstances or when there is insufficient time to appropriately incorporate relevant new information into the existing credit risk rating system or to re-segment existing groups of lending exposures, or

when lending exposures within a group react to factors or events differently than initially expected. For example, adjustments for macroeconomic factors should be part of the model used for determining ECL, as this is required on an ongoing basis, and should not be a temporary adjustment / overlay. On the other hand, any adjustments relating to a unique event that are not expected recur, for example Brexit, should be incorporated in the ECL computations using an overlay / temporary adjustment.

The use of temporary adjustments requires the application of significant judgment and creates the potential for bias. Temporary adjustments should be directionally consistent with forward-looking forecasts, supported by appropriate documentation, and subject to appropriate governance processes.

GUIDANCE ON ECL – BASEL COMMITTEE ON BANKING SUPERVISION

In December 2015, the Basel Committee published the final version of its Guidance on Credit Risk and Accounting for Expected Credit Losses (sometimes referred to as 'G-CRAECL'). The guidance was originally drafted for internationally active banks and more sophisticated banks in the business of lending. The final version does not limit its scope but allows less complex banks to apply, 'a proportionate approach' that is commensurate with the size, nature and complexity of their lending exposures. It follows that determining what is proportionate will be a key judgement to be made, which is likely to be guided in some jurisdictions by banking regulators.

The main section of the Basel Committee's guidance is intended to be applicable in all jurisdictions (i.e., for banks reporting under US GAAP as well as for banks reporting under IFRS) and contains 11 supervisory principles. The guidance is supplemented by an appendix that outlines additional supervisory requirements specific to jurisdictions applying the IFRS 9 ECL model.

It is important to stress that the guidance is not intended to conflict with IFRS 9 (and, indeed, this has been confirmed by the IASB), but it goes further than IFRS 9 and, in particular, removes some of the simplifications that are available in the standard. It also insists that any approximation to what would be regarded as an 'ideal' implementation of ECL accounting should be designed and implemented so as to avoid 'bias'.

Perhaps one of the most significant pieces of guidance provided by the Basel Committee relates to the important requirement in IFRS 9 that ECLs should be measured using 'reasonable and supportable information'.

The Committee accepts that in certain circumstances, information relevant to the assessment and measurement of credit risk may not be reasonable and supportable and should therefore be excluded from the ECL assessment and measurement process. But, given that credit risk management is a core competence of banks, 'these circumstances would be exceptional in nature'. It also states that management is expected 'to apply its credit judgement to consider future scenarios' and '[t]he Committee does not view the unbiased consideration of forward-looking information as speculative'. The guidance, therefore, establishes a high hurdle for when it is not possible for an internationally active bank to estimate the effects of forward-looking information.

A connected piece of the guidance relates to another important principle in IFRS 9, that reasonable and supportable information should be available 'without undue cost or effort'. The guidance states that banks are not expected to read this 'restrictively'. It goes on to say that, 'Since the objective of the IFRS 9 model is to deliver fundamental improvements in the measurement of credit losses ... this will potentially require costly upfront investment in new systems and processes'. Such costs 'should therefore not be considered undue'.

The requirements of the main section that relate to accounting include:

- There should be commonality in the processes, systems, tools and data used to assess credit risk and to measure ECLs for accounting and for regulatory capital purposes.
- When a bank's individual assessment of exposures does not adequately consider forward-looking information, it is appropriate to group lending exposures with shared credit risk characteristics to estimate the impact of forward-looking information, including macroeconomic factors. The grouping of lending exposures into portfolios with shared credit risk characteristics must be re-evaluated regularly (including re-segmentation in light of relevant new information or changes in the bank's expectations). Groupings must be granular enough to assess changes in credit risk and changes in a part of the portfolio must not be masked by the performance of the portfolio as a whole.

- 'Adjustments' may be used to address events, circumstances or risk factors that are not fully considered in credit rating and modelling processes. But the Committee expects that such adjustments will be temporary. If the reason for an adjustment is not expected to be temporary, then the processes should be updated to incorporate that risk driver. The guidance goes on to say that adjustments require judgement and create the potential for bias. Therefore, they should be subject to appropriate governance processes.
- The 'consideration of forward-looking information and macroeconomic factors is considered essential to the proper implementation of an ECL model. It cannot be avoided on the basis that the banks consider the costs to be excessive or unnecessary or because there is uncertainty in formulating forward looking scenarios'. However, the Committee recognises that an ECL is 'an estimate and thus may not perfectly predict actual outcomes. Accordingly, the need to incorporate such information is likely to increase the inherent degree of subjectivity in ECL estimates, compared with impairment measured using incurred loss approaches'. Also, the Basel Committee recognises that it may not always be possible to demonstrate a strong link in formal statistical terms between certain types of information and the credit risk drivers. Consequently, a bank's experienced credit judgement will be crucial in establishing the appropriate level for the individual or collective allowance.

The guidance is supplemented by an appendix that outlines additional supervisory requirements specific to jurisdictions applying the IFRS 9 ECL model. The key requirements are outlined below:

- It is recommended that a bank's definition of default adopted for accounting purposes be guided by the definition used for regulatory purposes, which includes both a qualitative 'unlikelihood to pay' criterion and an objective 90-days-past-due criterion, described by the Committee as a 'backstop'.
- The IFRS 9 requirement to assess whether exposures have significantly increased in credit risk 'is demanding in its requirements for data, analysis and use of experienced credit judgement'. The determination should be made 'on a timely and holistic basis', considering a wide range of current information. It is critical that banks have processes in place to ensure that financial instruments, whether assessed individually or collectively, are moved from

the 12-month to the lifetime ECL measurement as soon as credit risk has increased significantly. Credit losses very often begin to deteriorate a considerable period of time before an actual delinquency occurs and delinquency data are generally backward-looking. Therefore, 'the Committee believes that they will seldom on their own be appropriate in the implementation of an ECL approach by a bank.' Instead, banks need to consider the linkages between macroeconomic factors and borrower attributes, using historical information to identify the main risk drivers, and current and forecast conditions and experienced credit judgement to determine loss expectations. This will apply not only to collective assessments of portfolios, but also for assessments of individual loans.

- In assessing whether there has been a significant increase in credit risk, banks should not rely solely on quantitative analysis. The guidance draws banks' attention to the list of qualitative indicators set out in paragraph B5.5.17 of the standard. Consideration should be given to a list of conditions, including an increased credit spread for a particular loan, a decision to strengthen collateral and/or covenant requirements, a downgrade by a credit rating agency or within the bank's internal credit rating system, a deterioration in future cash flows, or an expectation of forbearance or restructuring. Also, the guidance stresses that the sensitivity of the risk of a default occurring to rating downgrades increases strongly as rating quality declines. Therefore, the widths of credit risk grades need to be set appropriately, so that significant increases in credit risk are not masked. Further, 'if a decision is made to intensify the monitoring of a borrower or class of borrowers, it is unlikely that such action would have been taken ... had the increase in credit risk not been perceived as significant'.
- Exposures that are transferred to stage 2 and that are subsequently renegotiated or modified, but not derecognised, should not be moved back to stage 1 until there is enough evidence that the credit risk over the remaining life is no longer significantly higher than on initial recognition. Typically, a customer would need to demonstrate consistently good payment behaviour over a period before the credit risk is considered to have decreased.

PILLAR 3 DISCLOSURES

Pillar 3 requires firms to publicly disclose information relating to their risks, risk sensitivities, reserving strategies, capital adequacy and policies for managing risk. The BCBS (Basel Committee on Banking Supervision) uses a 'three pillars' concept in banking regulation: Pillar 1 minimum capital requirements, Pillar 2 – supervisory review process, and Pillar 3 – market discipline, in 2004. Pillar 3 complements Pillar 1 and Pillar 2 and aims "to promote market discipline through regulatory disclosure requirements.

Pillar 3 requirements enable market participants to access key information relating to a bank's regulatory capital and risk exposures to increase transparency and confidence about a bank's exposure to risk and the overall adequacy of its regulatory capital" (Basel Committee on Banking Supervision, 2015).

The initial Pillar 3 requirements were subsequently revised in 2006 (see Basel Committee on Banking Supervision, 2006), to strengthen risk management. The 2007–09 financial crisis led to an amendment of the Pillar 3 framework by increasing the disclosure requirements for banks concerning various risks (see Basel Committee on Banking Supervision, 2009). A further revision led to the publication in January 2015 of an amendment (see Basel Committee on Banking Supervision, 2015) that aimed to improve comparability and consistency of risk disclosure.

MARKET RISK

One of the areas addressed by Pillar 3 disclosures is market risk. Market risk is defined as the risk of losses in on and off-balance sheet positions arising from adverse movements in market prices. Market risk stems from all the positions included in banks' trading book as well as from commodity and foreign exchange risk positions in the whole balance sheet. In the context of market risk Pillar 3 requires banks to provide the following information:

■ Qualitative disclosures on market risk

Provide a description of the risk management objectives and policies concerning market risk:

1. Strategies and processes of the bank: an explanation of management's strategic objectives in undertaking trading activities, as

well as the processes implemented to identify, measure, monitor and control the bank's market risks, including policies for hedging risk and strategies/processes for monitoring the continuing effectiveness of hedges.

2. Structure and organisation of the market risk management function: description of the market risk governance structure established to implement the strategies and processes of the bank discussed above and describing the relationships and the communication mechanisms between the different parties involved in market risk management.
3. Scope and nature of risk reporting and/or measurement systems: Provide the scope, the main characteristics and the key modelling choices of the different models (VaR, stressed VaR, IRC, CRM) used for regulatory calculation of market risks. Describe the main characteristics of the models used at the group-wide level (according to the scope of regulatory consolidation) and explain to what extent they represent all the models used at the group-wide level. The commentary must include the percentage of capital requirements covered by the models described for each of the regulatory models (VaR (Value at Risk), stressed VaR, IRC (Incremental Risk Charge), Comprehensive Risk Measure).

■ Quantitative disclosures on market risk

4. The components of the capital requirement under the standardised approach for market risk with narrative commentary to explain any significant changes in the reporting period and the key drivers of such changes.
5. A flow statement explaining variations in the market RWA (Risk Weighted Assets) determined under an internal model approach with narrative commentary to explain any significant changes in the reporting period and the key drivers of such changes.
6. The values (maximum, minimum, average and period ending for the reporting period) of trading portfolios resulting from the different types of models used for computing the regulatory capital charge at the group level, before any additional capital charge is applied by the jurisdiction with narrative commentary to explain any significant changes in the reporting period and the key drivers of such changes.

7. Present a comparison of the results of estimates from the regulatory VaR model with both hypothetical and actual trading outcomes, to highlight the frequency and the extent of the backtesting exceptions, and to give an analysis of the main outliers in backtested results. Present an analysis of “outliers” (backtesting exceptions) in backtested results, specifying the dates and the corresponding excess (VaR-P&L). The analysis should at least specify the key drivers of the exceptions. For actual P&L: provide information about actual gains/losses, and especially clarify whether they include reserves, and if not, how reserves are integrated into the backtesting process; also clarify whether actual P&L includes commissions and fees or not.

INTEREST RATE RISK IN THE BANKING BOOK

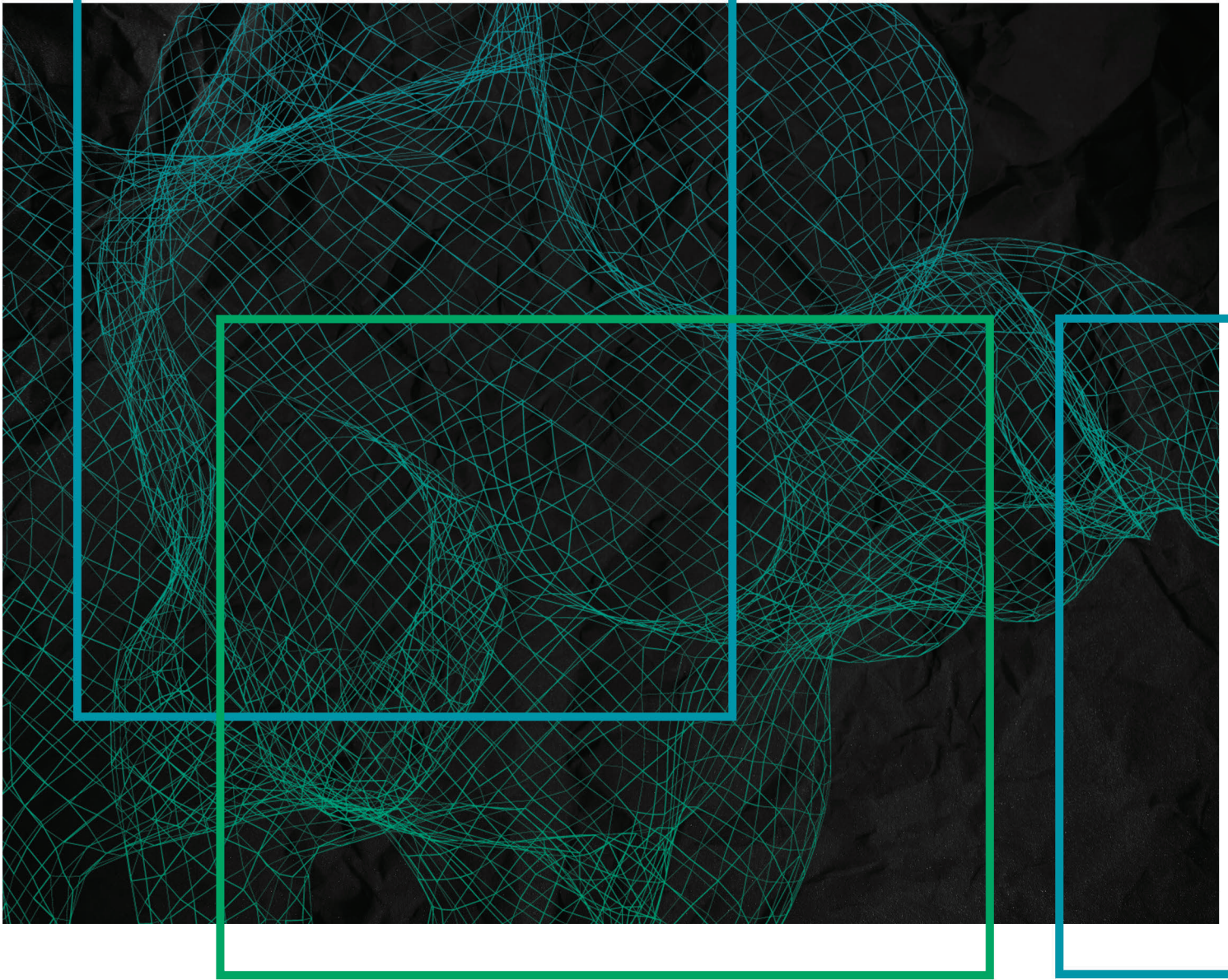
In addition to market risk Pillar 3 disclosures also require that banks present the following information on the Interest Rate Risk in the Banking Book (IRRBB)

- Qualitative disclosures: The nature of IRRBB and key assumptions, including assumptions regarding loan prepayments and behaviour of non-maturity deposits, and frequency of IRRBB measurement.
- Quantitative disclosures: The increase (decline) in earnings or economic value (or relevant measure used by management) for upward and downward rate shocks according to management’s method for measuring IRRBB, broken down by currency (as relevant).

DIFFERENCES BETWEEN PILLAR 3 DISCLOSURES AND GENERAL PURPOSE FINANCIAL REPORTING REQUIREMENTS

Whilst the objectives of Pillar 3 reporting are similar to those of IFRS 7 risk management disclosures, supervisors should be aware that Pillar 3 reporting is different from banks’ financial reporting along several dimensions:

- Pillar 3 reporting is regulated by the Basel Committee, follows the Basel Rules and not financial reporting requirements.
- General purpose financial reporting covers a bank’s financial information on accounting measurement and disclosure, while the information disclosed in Pillar 3 is related to a bank’s risk exposure and risk management, referred to as “risk reporting.”
- Banks may publish their Pillar 3 report in a standalone document or in a discrete section of banks’ financial reporting
- The frequency of Pillar 3 reporting varies between quarterly, semi-annual, or annual frequency, which is specified by jurisdictional requirements.
- Pillar 3 information is not mandatorily audited in all jurisdictions but must be subject to internal review and control.



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