# Putting it all together: IAS 32 and IFRS 7

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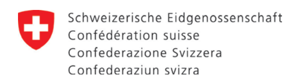

# Outline

## Interaction between IFRS and prudential reporting

» What does research tells us?

» Impact of IFRS 9 implementation?

» Phased approach for impact on regulatory capital

» ESMA requirements to evaluate IFRS 9 impact and disclose

## IFRS 7

» Overview IFRS 7

» IAS 1 Disclosure requirements

» Disclosure requirements credit risk

» Disclosure requirements market risk

» Examples credit risk and market risk disclosures

# Accounting vs Prudential: different objectives, similar outcomes

- Prudential requirements aim at protecting the depositors and creditors
- Financial reporting is primarily aimed at investors event if taking into account creditors in making decision about providing resources to the entity
- Both are aiming at reducing the information asymmetry between respectively depositors and management and investors and other creditors and management
- All actors have interest that the bank is a going concern

# What does research tells us?

- BCBS WP 31 (July 2013): the interplay of accounting rand regulation and its impact of bank behavior
  - Provision depend largely on backward looking information (NPL ratios, spreads at origination) which questions their timeliness and adequacy
  - No clear evidence of cyclicality except if discretionary provisions are allowed; then these provision tend to go up as macro economic conditions deteriorate
  - Backward looking amplifies the downturn
  - Bank subject to market discipline holds greater amount of capital
  - Capital ratios and amounts of level 3 assets are correlated
  - Fluctuation of capital would have been larger if AFS were not a prudential filter

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- EBA: SECOND IMPACT ASSESSMENT OF IFRS 9 13 July 2017: findings
- Implementation efforts are continuing progress made. Fewer banks at the design phase and more at the building testing phase.
- Estimated quantitive impact given the current market conditions of IFRS 9 application on CET1 ratio and total capital ratio is limited overall. On average 45 BP on CET1 decrease, on total capital ratio 35 bp.
- More information provided by the banks quantitatively and qualitatively, i.e. explaining the quantitative impacts
- Smaller banks tend to have a larger impact on own funds ratio. Smaller banks use the standardized approach and larger banks the IRB ones.
- EBA concerned that 19 per cent of respondent will not have any parallel run between IAS 39 provisioning and IFRS 9 provisioning.l
- Importance of IFRS 9 disclosure and being able to provide sufficient information for the user to understand the impact of IFRS 9 and understand the behavior of IFRS 9 numbers against IAS 39

- EBA: SECOND IMPACT ASSESSMENT OF IFRS 9 13 July 2017 (Continued): challenges
  - insufficient allocation of resources linked to the absence of involvement of the board members and the audit committees
  - Data quality, availability of historical data, and assessments of the significance of credit risk, together are most significant challenges for banks.
  - Need to apply a sound methodology and governance process when making simplifications
  - Classification and measurement will have a limited impact for most banks but this impact still needs to be assessed, and the implementation challenges should not be underestimated
  - Banks using SA will not be able to reintegrate excess provision under IFRS 9 as compared to regulatory expected losses in Tier 2 capital.

# Phase-in of the impact of IFRS 9 in regulatory capital

- Letter de Daniele Nouy, Chair of the supervisory board to the European Parliament (July 13, 2017)
  - A decision of the competent authority not at discretion of credit insitutions
  - Phase-in of the impact of IFRS 9 on CET 1 during the transition period possible
  - Not for more time to apply IFRS 9 but to deal with consequence on regulatory capital. Delaying the implementation of IFRS 9 would not resolve the ‘too little to late issue’
  - Beware of double counting (non -deducted deferred tax assets) reductions of exposures under the standardized approach for credit risk
  - Straight line amortization, no 100 % increase..)
  - But … support for considering the full impact on CET 1

- Public Statement on the implementation of IFRS 9 (10 November 2016)
- Application of para 30 of IAS 8: impending change in accounting policies disclosure requirements
  - Disclose the change in policy
  - Disclose the financial impact: *known reasonable estimate information relevant to assessing the relevant impact of the standard… in the period of first application*
  - *Importance of looking at impact on risk management and ensure consistency of application in a group*
  - FS 2017 should disclose the financial impact and explain changes in the amounts reported under IAS 39.

# IFRS 7 disclosures

- This section covers IFRS 7 Disclosures and focuses mainly on market and credit risk

# Overview – IFRS 7

- IFRS 7 issued in 2005 and replaced IAS 30 and IAS 32
- IFRS 7: Disclosures about all financial instruments
- IFRS 7 disclosure requirements incorporated many of the requirements of IAS 32
- There are exceptions: such as pensions, insurance contracts, etc.
- Applicable to all entities even if they have only a few financial instruments
- But the extent of disclosure required depends on their use of financial instruments and exposure to risk

- Qualitative and quantitative disclosures i.e. words and numbers
- The IASB believes that users of financial statements need information about an entity’s exposure to risks and how those risks are managed
- Disclosures in IFRS 7 are around 3 main areas: Credit risk, market risk and liquidity risk

# Amendments to IFRS 7

- A number of amendments made to IFRS 7 pre and post crisis
- March 2009 – enhanced disclosures about fair value measurements and liquidity risk
- October 2010 – transfers of financial assets – to help users of financial statements evaluate the risk exposures relating to transfers of financial assets and the effect of those risks on an entity’s financial position

- IAS 1 also include a number of key disclosure requirements:
  - Summary of significant accounting policies
  - Measurement basis
  - Accounting policies used that are relevant to an understanding of the financial statements

- The disclosure requirements in IAS 1 are directly related to the disclosure requirements in IFRS 7

# IFRS 7 disclosure requirements

- According to IFRS 7: Providing qualitative disclosures in the context of quantitative disclosures enables users to link related disclosures and form and overall picture of the nature and extent of risks arising from financial instruments
- According to IFRS 7: The interaction between qualitative and quantitative disclosures contributes to disclosures in a way that better enables users to evaluate an entity’s exposure to risk
- What does the above mean?
  - Important that words and numbers complete each other and are meaningful to users
  - Words explain the numbers
  - Words should be relevant and not “boiler-plate”
  - Words should be contextual

# IFRS 7 disclosure requirements

- Qualitative disclosures (for market, credit and liquidity risk)
  - For each type of risk arising from financial instruments, an entity shall disclose:
    - The exposures to risk and how they arise
    - Its objectives, policies and processes for managing the risk and the methods used to measure the risk
    - Any changes from previous periods

# IFRS 7 disclosure requirements

- Classes of financial instruments and level of disclosure
  - When disclosure requirements are by class of financial instruments, an entity shall group them by classes that are appropriate to the nature of the information disclosed and that take into account the characteristics of those financial instruments.
  - An entity shall provide sufficient information to permit reconciliation to the line items presented in the statement of financial position
- Implications
  - Users should be able to see the trail from notes to statement of financial position and vice-versa
  - Information should be sufficiently detailed ie too much aggregation not useful
  - Not to confuse between classes and categories (4 in IAS 39)

# IFRS 7 disclosure requirements – Credit risk

- By class of financial instruments
  - The amount that best represent its maximum exposure to credit risk without taking into account collateral
  - Description of collateral held as security
  - Information about credit quality of financial assets that are neither past due nor impaired
  - For either past due or impaired financial assets:
  - An analysis of the age of financial assets that are past due as at the end of the reporting period but not impaired; and
  - An analysis of financial assets that are individually determined to be impaired as at the end of the reporting period , including the factors the entity considered in determining that they are impaired
  - If collateral meets the recognition criteria in other IFRSs, an entity shall disclose the nature and carrying amount of the assets

» Credit risk: the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation

» Past due: a financial asset is past due when a counterparty has failed to make a payment when contractually due

- Disclosures required for credit risk (and also market and liquidity risk) should be given in the financial statements or incorporated by cross-reference from the financial statements to management commentary or risk report available to users of the financial statements
- Without the information incorporated by cross-reference, the financial statements are incomplete
- When management uses several methods to manage risks, the entity shall disclose information using the method or methods that provide the most relevant and reliable information

# IFRS 7 disclosure requirements – Market risk

- Market risk: The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises 3 types of risk: currency risk, interest rate risk and other price risk
- Currency risk: The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates
- Interest rate risk: The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates
- Other price risk: The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices (other than interest rate or currency risk) e.g. equity or commodity

# IFRS 7 disclosure requirements – Market risk

- » Sensitivity analysis
- » To reflect the impact of market risk on the valuation of the financial instruments, the entity shall disclose a sensitivity analysis for each type of market risk, showing how profit or loss and equity would have been affected by changes in the relevant risk variable that were reasonably possible at that date
- » To disclose: Methods and assumptions used in preparing the sensitivity analysis
- » To disclose: Changes from previous period in the methods and assumptions used and reasons for such changes

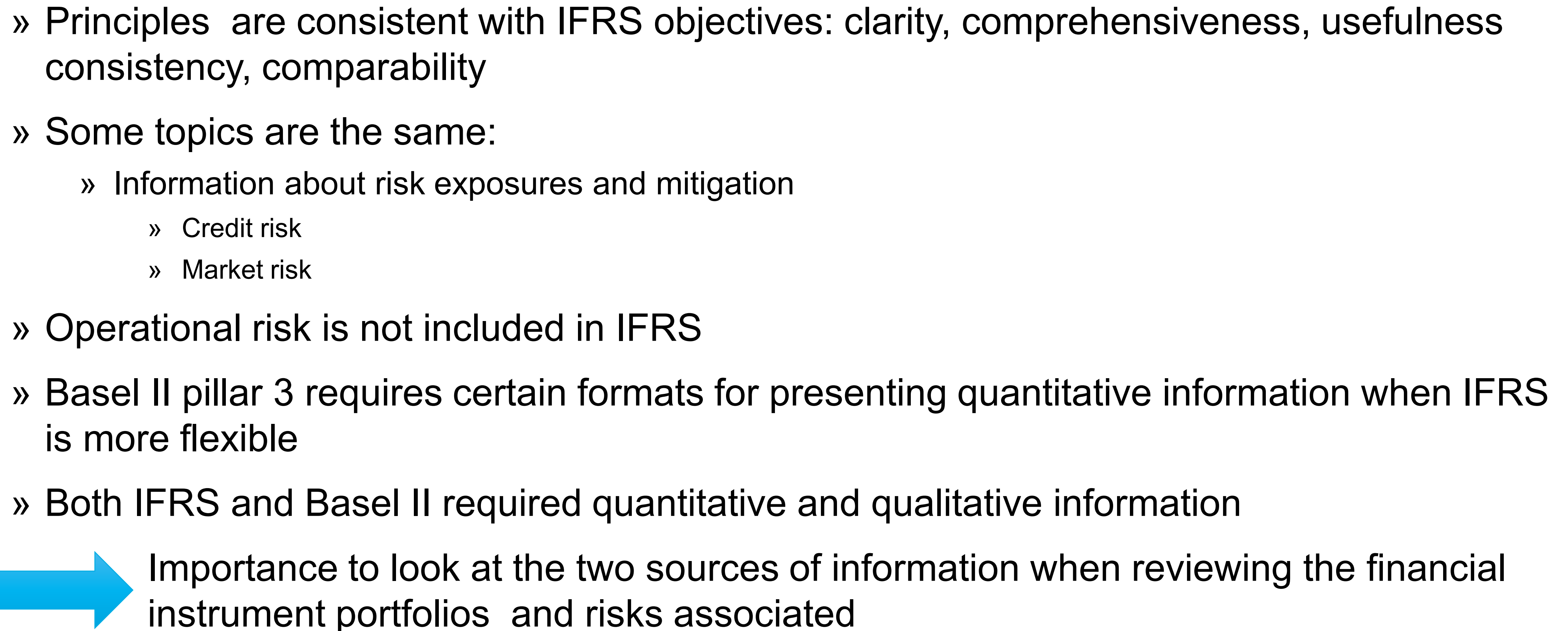
# IFRS 7 disclosure requirements – Market risk

» Sensitivity analysis is a kind of stress test with less radical assumptions

» Although supervisors may have access to more detailed data re. sensitivity analysis or may require firms to perform more stringent tests on the impact of market risks on profit and loss and capital, the IFRS 7 disclosures on market risk is a good place to start

» Supervisors can also review these disclosures to check for consistency with prudential data

# Basel 2 with Pillar III disclosures and IFRS 9



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