

E MAIN EFFECTS FROM THE NEW ACCOUNTING FRAMEWORK ON BANKS

The EU Regulation requiring all listed companies, including banks, to prepare consolidated financial statements in accordance with International Financial Reporting Standards (IFRS) has been a positive development that will increase the transparency and comparability of financial statements in the EU. However, the first-time application of these new rules will have a significant impact on financial statements which should be taken into account when analysing the accounting figures. The aim of this Special Feature is to provide a brief overview of the main ways in which IFRS will affect banks' primary financial statements.

INTRODUCTION

Regulation 1606/2002/EC¹ concerning the application of IFRS² was adopted by the European Parliament and the EU Council on 19 July 2002. According to this Regulation, for each financial year starting on or after 1 January 2005, all companies listed in the EU, including banks, are required to comply with the accounting and financial reporting standards issued by the International Accounting Standards Board (IASB) with regard to their consolidated accounts. In order to become effective in the EU, each individual IASB standard is required to be endorsed by the EU Commission. At this juncture, however, it should be noted that the standard concerning the recognition and measurement of financial instruments (IAS 39), which is extremely important to the banking industry, has only been partially endorsed and, in that context, certain hedging provisions have been carved out. It should in addition be noted that the Regulation also contains the option for Member States to extend the application of IFRS to financial statements of individual firms and to unlisted companies.

The purpose of this Special Feature is to highlight the likely main effects from the

introduction of the new accounting rules for banks. Changes in the new EU accounting framework may potentially affect the indicators used in the Financial Stability Review in two main ways. First, one-off effects could arise in the financial statements owing to the transition from national accounting principles to the new framework. Such one-off effects would affect the components of the macro-prudential indicators. This sort of change in the indicators is independent of underlying changes in the stability of the financial system. Second, following the introduction of the new framework, balance sheet items are likely to display different time series behaviour compared to that under the current national rules. Such differences could for instance materialise in higher or lower volatility or in altered sensitivity of accounting figures to market factors such as changes in interest rates or prices for shares. Consequently, changes in the prudential indicators need to be interpreted with care during the transition phase.

The aggregate impact of the changes introduced by IFRS on the banking sector as a whole is, however, impossible to assess ex ante. Indeed, the overall impact very much depends on the composition and structure of each bank's balance sheet. The accounting rules currently in place also play an important role, as some national standards are quite similar to IFRS, while others significantly differ. Finally, the overall impact also depends on the accounting practices of individual firms and their use of different options incorporated into the accounting rules.

Notwithstanding the above-mentioned difficulties in assessing the impact of the introduction of the new accounting framework, this Special Feature tries to identify the main changes in the accounting rules which are

¹ Generally known as the "IAS Regulation".

² International accounting standards issued by the London-based International Accounting Standards Board (IASB).

relevant for banks and may have a significant impact on their balance sheets and income statements.

It is important to note that the effects of the new accounting framework will not materialise to an equal extent in all the various financial indicators or reporting. Indeed, prudential reporting based on individual accounts would not necessarily³ be affected by the new rules, contrary to consolidated prudential ratios based on consolidated accounting figures. Furthermore, some effects in the calculation of regulatory capital will be mitigated through internationally agreed “prudential filters” (see section below concerning the impact on regulatory capital). Hence, indicators concerning regulatory capital (e.g. solvency ratios) which are associated with prudential filters may be affected by the new accounting framework in a different way than indicators that rely on the accounting definition of equity capital (e.g. ROE).

This Special Feature focuses upon the following areas: (i) reclassification of instruments as debt or equity; (ii) accounting for business combinations; (iii) valuation of financial instruments, which also includes the recognition of derivatives, available-for-sale securities, hedging provisions, the fair value option, share-based payments and allowances for credit losses and own credit risk; (iv) measurement of post-employment benefits; (v) de-recognition of special purpose entities; (vi) dividend adjustment; and (vii) software and other intangibles.

Finally, the article ends with a brief discussion on the prudential filters used by banking supervisors with the aim of safeguarding the definition and quality of regulatory capital.

RECLASSIFICATION OF DEBT AND EQUITY INSTRUMENTS

The definition of debt and equity classification principles applicable to capital instruments differ under IFRS compared to most national

accounting rules. According to IFRS, issued instruments are classified as liabilities when the issuer has a present obligation to deliver cash or another financial asset to the holder of the instrument.

Hence, the introduction of IFRS has entailed the reclassification of certain debt and equity instruments. For example, certain capital instruments such as preference shares that were previously treated and recognised as equity will now need to be reclassified as liabilities. IFRS distinguish equity from non-equity preference shares on the basis of whether the dividends paid out on the share are mandatory or discretionary. In the former case, preference shares are required to be reclassified as liabilities, which will result in a negative adjustment in equity. It should be noted that non-equity minority interest, which is recognised under equity on the balance sheet, may also need to be reclassified into liabilities. This may have a potentially negative impact on net income, as the reclassification results will affect the interest expense.

Conversely, certain instruments (e.g. reserve capital instruments) previously recognised as liabilities will be reclassified as minority interest, which is presented within shareholders’ equity on the balance sheet. This reclassification will result in a decrease in interest expense.

The overall impact of the reclassification of debt and equity instruments on equity and on net income greatly depends on the specific composition of individual banks’ balance sheets.

It should be noted that for prudential purposes, the current definition of own funds will be maintained, and hence the potentially different accounting classifications of debt and equity instruments will not affect regulatory capital.

³ In cases where firms are required or provided with an option to use IFRS for their individual accounts, prudential reporting based on individual accounts could be similarly affected by IFRS.

BUSINESS COMBINATIONS

When combining businesses through the acquisition of another business, the acquirer typically pays a price that differs from the net book value of the assets and liabilities of this business. This difference, which is typically a positive amount, is referred to as goodwill. Prior to the introduction of IFRS, most national standards required such goodwill to be amortised according to a predetermined schedule or for it to be fully written off immediately after the acquisition. Hence, the treatment of goodwill differs across entities within a jurisdiction.

Two main observations may be made from comparison of the new framework with current national rules. First, the measurement of goodwill deserves attention. Under IFRS 3, the currently applicable standard for business combinations under the new framework, goodwill is measured by allocating the cost of the acquisition to the fair values of identifiable assets and liabilities of the acquired business. The excess of costs then constitutes the goodwill. This can differ from current national rules, where merger accounting⁴ may imply zero goodwill, where more flexibility may be available in allocating the cost of the acquisition to balance sheet assets, and where goodwill might not reflect fair values.

Second, under IFRS, goodwill is recognised as an asset that must not be regularly amortised. Rather, it needs to be tested for impairment, i.e. it is regularly tested to establish whether the present value of the business units still justifies the reported goodwill. If not, an impairment loss is recognised that cannot be recovered later. By contrast, negative goodwill at the time of the acquisition is immediately recognised in profit and loss.

The ongoing effect of IFRS 3 is that income-based financial indicators are not necessarily weakened following an acquisition or a merger. Furthermore, the ongoing amortisation of past acquisitions will cease, improving earnings in

principle. In the long run, it is however unclear whether the impairment tests will effectively lead to a quicker writing off of the goodwill than regular amortisations, although in a less smooth fashion. If the economics of a merger have been overestimated and the acquisition was overpriced, this may become apparent before the end of the regular amortisation schedule, thus triggering a full write-off of the goodwill. It is moreover safe to assume that changes in goodwill and related effects on equity and income will in the future occur in a more discrete, volatile fashion and will, in line with the expected returns from the acquired or merged unit, behave cyclically. It is likely that during a recession, goodwill positions will evaporate faster from banks' balance sheets than under the current long-term amortisation schedules.

An interesting feature of possible one-off effects is that in principle, IFRS 3 accounting can be, but does not have to be, applied to past acquisitions, which means that the original goodwill could be reactivated, undoing past amortisation through profit and loss with corresponding effects on income and, most notably, on book equity.

Goodwill accounting clearly influences indicators that are based on equity and assets, and changes in the amortisation of goodwill influence earnings. However, regulatory own funds will not be affected because the definition of own funds excludes intangible assets. Furthermore, goodwill is not risk-weighted and thus does not affect the numerator of the solvency ratio. Consequently, the solvency ratio remains unaffected by changes in goodwill accounting. For instance, a one-off increase in reported goodwill at the first-time application of IFRS would increase shareholders' equity; however, for the own funds, the effect is eliminated because of an increase in the deductions from the own funds of the same amount.

⁴ This is also referred to as pooling of interest accounting.

FINANCIAL INSTRUMENTS

DERIVATIVES

IFRS require all derivatives to be recognised on the balance sheet and measured at fair value. Gains and losses from changes in the fair value will flow through the income statement, with the exception of derivatives qualified for hedging (see section on hedging provisions). Prior to the adoption of IFRS, derivatives held for trading were already valued at fair value in many European countries and recognised on the balance sheet. However, this is a new feature for derivatives recognised in the banking book, as these were formerly only registered off-balance sheet at cost.

Additionally, derivatives that are embedded in hybrid financial instruments, but which have economic characteristics and risks that are not closely related to the economic characteristics of the underlying financial instrument, are required to be separated from the hybrid instrument, to be valued at fair value and recognised on the balance sheet on a stand-alone basis.

The recognition of derivatives at fair value will result in an increase in the overall size of the balance sheet. Furthermore, changes in the fair value will cause additional volatility in the income statement and, therefore, also in equity. However, it should be stressed that the recognition of derivatives on the balance sheet at fair value, as opposed to the current situation of generally simply being registered off-balance sheet, can be considered a significant step forward for users of financial statements, as it increases understanding of the underlying risks incurred by banks which may be dealing with and exposed to derivatives transactions on a large scale.

AVAILABLE-FOR-SALE SECURITIES

Under IFRS, available-for-sale (AFS) securities are required to be recorded at fair value. Under certain national accounting rules, AFS securities could include long-term investments which were carried at cost, less

provisions for impairment. For these assets, the introduction of IFRS seems, in most cases and at this juncture, to result in an increase in value from the recognition of these assets at fair value.⁵ The increase from cost to fair value will be recognised in a specific reserve of shareholders' equity. Hence, this increased use of fair value for AFS securities may potentially result in an increase in the overall asset size of the balance sheet and in an increase in the volatility of equity.

The accounting treatment of AFS securities has indeed prompted banking supervisors to develop a prudential filter to neutralise the effect on regulatory capital (see section on the impact on regulatory capital).

HEDGING PROVISIONS

Hedge accounting rules allow the hedging item to follow the accounting treatment of the hedged item, which is generally known as accruals accounting. Under this treatment, the gain or loss on the hedging instrument is recognised in the income statement when the offsetting gain or loss on the hedged instrument is recognised. Hence, given the possibility to defer or anticipate income recognition, strict requirements need to be complied with in order to qualify for hedge accounting so as to prevent discretionary income manipulation by management. To qualify for hedge accounting, IFRS require, inter alia, specific identification and documentation of the hedging and hedged instruments, identification of the risk being hedged, and effectiveness testing of the hedge itself. IFRS also allow macro-hedging (on a portfolio basis) in a fair value hedge for interest rate risk.

IFRS distinguish between two main types of hedges: cash-flow hedges and fair value hedges. Cash-flow hedges aim to cover the risk of variability of future cash flows (e.g. variable rate financial instruments), and the valuation of

⁵ Fair values can be higher or lower than amortised cost, depending on the changes in interest rates and the amount that the asset was recognised as on the balance sheet.

the hedging derivative is recognised at fair value in shareholders' equity. As the gains and losses from the changes in the fair value of the hedged instrument are recognised in the income statement, the fair value of the hedging instrument recognised in equity is adjusted and the corresponding gains and losses are "recycled" through the income statement. It should be noted that the accounting treatment of cash-flow hedges was also subject to a prudential filter to safeguard the quality of regulatory capital (see section on the impact on regulatory capital).

Fair value hedges are designed to cover changes in the price of a financial instrument. This can be accomplished by hedging the transaction (micro hedging) or on a portfolio basis (macro hedging). Under micro fair value hedging, changes in the fair value of the derivative and changes in the fair value of the hedged item are recognised in the income statement symmetrically. For macro hedging, the change in the fair value of the hedged item is recognised in the balance sheet on a separate line item.

Hedge accounting rules were in place prior to the introduction of IFRS. However, the IFRS criteria seem to be tighter than existing national hedging rules. Therefore, some existing hedging relationships may fail to comply with the IFRS hedging criteria, and thus will no longer qualify for hedge accounting, which may subsequently result in artificial volatility in net income.

FAIR VALUE OPTION

The new accounting rules introduce the possibility to designate irrevocably at inception a financial asset or financial liability as at fair value through profit and loss – the so-called fair value option. However, this option may only be applied if: (i) it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an accounting mismatch), or (ii) when a group of financial assets, financial liabilities or

both is managed and its performance is evaluated on a fair value basis in accordance with a documented risk management strategy.⁶

Although the introduction of this option may increase the use of fair value, which could potentially entail additional volatility in net income from the changes in the fair value, it also allows the elimination of an accounting mismatch of an economically hedged position (thus reducing "artificial" volatility).

SHARE-BASED PAYMENTS

Under IFRS, banks are required to recognise in their income statements the fair value of share options and other share-based payments awarded by banks to their employees and executives. Under current rules there is no such requirement, and such share-based payments are kept off-balance sheet. This expense will have a one-off negative impact on net income.

ALLOWANCES FOR CREDIT LOSSES

Loans are traditionally recognised on the balance sheet at cost. Banks have some discretionary leeway in classifying certain loans as doubtful or non-performing, and in calculating the related provision for loan losses, which could be either general or specific. Specific provisions cover losses on individual or on a portfolio of loans which have been specifically identified as impaired or non-performing. The nature of general provisions varies significantly across Member States, from statistically supported allowances for losses inherent in the loan portfolio to country risk reserves or reserves for general banking risks (which are not associated with an impairment).

Under IFRS, banks will be required to assess at each balance sheet date whether there is objective evidence that the loan or group of loans is impaired. An impairment loss should

⁶ See IAS 39 "Financial Instruments: Recognition and Measurement", Amendment to IAS 39 for Fair Value Option, June 2005.

be recorded when it is probable that the bank will not receive the payment of interest and principal according to the original contractual terms. The amount of the loss is the difference between the carrying amount and the net present value of expected future cash flows discounted at the loan's original interest rate. This loss, recognised as an allowance for loan losses, will flow through profit and loss. In addition, for collateralised loans, banks will need to recognise collateral at fair value.

The recording of impairment losses will increase the potential pro-cyclical effects on banks' profit and loss. Furthermore, these new rules may result in a reduction in the overall level of allowances for credit losses, as banks will only be allowed to create reserves⁷ to cover losses which have been incurred. This need not, however, lead to insufficient provisions. The new rules require a two-step assessment of incurred credit losses, whereby loans are assessed individually and collectively. An individual loan which has been determined as not impaired is included in a group of loans with similar credit risk characteristics for collective impairment assessment. The process considers all credit exposures, not only those of low credit quality. Where observable data are limited, the new rules require the use of experienced judgement in the estimation process. A potential reduction in the allowance expense for credit losses will have a positive impact on net income.

POST-EMPLOYMENT BENEFITS

Pensions are the most significant position in the category of post-employment benefits under the IFRS. In this context, a pension plan asset or liability is recognised on the balance sheet only if the employer bears the investment and actuarial risks of the pension plan. If this is the case (e.g. in the case of defined benefit schemes), either a net asset or a net liability is reported, based in principle on the difference between the fair value of pension plan assets and the actuarial, discounted present value of future pensions.

The one-off effects of the first-time application of IFRS can basically materialise in three different respects. First, pension plan assets and liabilities may currently not be recognised on the balance sheet at all, even though the plan is of a defined benefit nature. In these instances, the one-off expense and the additional liability appearing on the balance sheet will obviously be significant and will strongly influence both income-based indicators and capital ratios. However, even if currently applicable rules require the recognition of pension liabilities, it is likely that the amount of the liabilities will increase under IFRS, given that the actuarial factors to be accounted for are rather extensive compared to the often less binding or limited guidance given by national rules. Second, the measurement of the pension plan assets may in certain cases produce precisely the opposite effect. Where pension plan assets were not designated as such in the past under national accounting rules and did not offset pension liabilities, the effect may be that the net liability under IFRS is actually lower than the liability currently reported, implying a positive effect on income and equity in the transition to IFRS. Third, a similar situation may also arise when there are considerable hidden reserves in pension plan assets that would be disclosed and netted against pension plan liabilities upon first-time application.

With regard to ongoing effects, it can be assumed that the measurement of pension plan assets at fair value and the relatively stringent actuarial methods in connection with the requirement to update regularly the calculations will tend to lead to increased volatility of profit and loss compared to measurement under most of the current national rules. However, it should be noted that if actuarial gains or losses exceed certain thresholds, IFRS allow them to be spread at maximum over the average remaining service period of the employees, which would

⁷ The term "reserve" is meant as a provision or allowance in the context of loan impairment.

contribute to smoothing their impact on net pension assets or liability and on profit and loss. There is also the possibility that firms might try to avoid these effects on their balance sheets in the medium term by increasingly opting for defined contribution pension schemes.

SPECIAL PURPOSE ENTITIES

The main issue in this context is whether the assets and liabilities of a special purpose entity (SPE) should be included in the individual accounts of a bank, and whether the SPE needs to be consolidated. SPEs are of particular relevance in the banking sector because they are used as a conduit for securitisations of banks' assets such as credit portfolios (in such cases, the bank sells the assets to an SPE that has issued securities, and pays those assets with the proceeds from this issuance). While ideally such a transaction, also referred to as a "true sale", would insulate the bank from the risks and returns of those assets and would thus justify their de-recognition from the bank's balance sheet, there are various issues that imply continued risks for the selling bank, such as retained tranches of the securitisation or implicit support for the SPE. Other potential uses of SPEs for banks include the selling of non-core activities such as real estate holdings.

IFRS contain specific provisions on securitisation. The possibility that securitised assets may be de-recognised from the bank's balance sheet requires a case-by-case analysis. As a first step, it needs to be analysed whether the bank bears the risks and returns of the assets. The level of control the bank has over the SPE also has to be assessed. Consolidation as opposed to inclusion in individual accounts is, by contrast, required if the bank controls the SPE, i.e. when it has for instance the ability to appoint its management or issue orders to the SPE.

In some cases IFRS appear somewhat more concrete and binding than some current national accounting principles (for instance the

German and French). Others (for instance the Dutch and British) are more similar to IFRS. Consequently, it is likely that in the first cases (but rather not in the latter) that some SPEs will need to be included in the individual and/or consolidated accounts for the first time. This assessment is obviously a static one in the sense that IFRS also allow SPEs in principle to be structured in a way that they do not have to be included. Consequently, some reporting entities may choose to restructure transactions rather than to recognise them on their balance sheets.

In those cases where existing, off-balance sheet SPEs need to be included on the balance sheet, there will be a one-off increase in assets and liabilities and a consequent change in return on total assets and in the debt-to-equity ratio. Solvency ratios, by contrast, would remain unaffected as the capital treatment of the securitised assets and the retained tranches depends on the respective prudential rules, irrespective of the accounting treatment.

DIVIDEND ADJUSTMENT

Under national accounting rules, dividends are recognised as soon as they are declared. However, under IFRS dividends are only recognised later when approved and not when initially declared. This results in a positive adjustment in equity for year-end accounts. However, this adjustment is temporary, given that it will be corrected for in interim accounts, when the declared dividends are effectively approved for distribution. This adjustment is particularly large for some countries.

SOFTWARE DEVELOPMENT COSTS AND OTHER INTANGIBLES

According to most current national accounting rules, banks have the option either to expense or to capitalise certain software development costs. Under IFRS, these internally developed software and other intangible assets can be capitalised and amortised, but only if certain conditions are met. Therefore, for banks which

had previously chosen to expense their software development costs, the transition to IFRS and the retroactive application of this rule would imply an increase in the asset size of the balance sheet from the capitalisation of these costs and an increase in equity from the related positive adjustment.

However, the annual amortisation of these costs, which are normally amortised over a short period of time, will subsequently, at year-end, have a negative effect on the income statement.

PRUDENTIAL FILTERS

The impact of the application of the new accounting standards may in certain cases be significant on equity and on the income statement. Given that these accounting figures are normally used as the basis for prudential reporting, banking supervisors deemed it necessary to develop some prudential filters.

Prudential filters are designed to maintain the current definition and quality of regulatory capital. It should be noted that with the objective of maintaining a level playing-field across the EU and G10 countries, the prudential filters proposed by the Committee of European Banking Supervisors are consistent with those of the Basel Committee on Banking Supervision.

A brief description of some of these prudential filters is provided below; a detailed description of all the prudential filters developed by the above-mentioned committees can be found on their respective websites.⁸

OWN CREDIT RISK

Banking supervisors advise the exclusion from regulatory capital of any cumulative unrealised gains and losses arising from changes in an institution's own credit standing – so-called own credit risk – as a result of the potential future application to liabilities of the fair value option. When issued liabilities are recognised at fair value in a bank's balance sheet, a

deterioration in the bank's credit quality leads to an increase in the discount, which results in a reduction in the value of the liabilities and in turn to the recognition of an accounting gain. Conversely, an improvement in the bank's creditworthiness leads to an increase in the fair value of the liabilities (discounted at a lower rate), which results in the recognition of an accounting loss. Banking supervisors advise that these gains and losses should be extricated from regulatory capital.

CASH-FLOW HEDGES

It is recommended that fair value reserves related to cash-flow hedges of financial instruments measured at amortised cost should not be included in regulatory capital, given that this fair value reserve will be subsequently adjusted and the related gains and losses recognised through profit and loss.

AVAILABLE-FOR-SALE PORTFOLIO

The AFS portfolio comprises equities, loans and receivables and other financial instruments. For equities, unrealised losses should be deducted from regulatory capital (more specifically from tier one), while unrealised gains should only partially be included (in tier two). For loans and receivables, unrealised gains and losses – apart from those related to impairment – are not recognised in regulatory capital. Other AFS assets are either treated as equities or as loans and receivables.

CONCLUDING REMARKS

To sum up, the changeover from national accounting rules to IFRS may raise issues of interpretation or comparison in the near future. This is particularly true at the EU-wide macro level, given that the concrete nature and size of the effects from the transition to IFRS will depend on both the pre-existing national rules in each Member State and the current practices and specific features of individual firms that have been applying the national rules. From a

⁸ www.c-eps.org and www.bis.org/bcbs/index.htm.

financial stability perspective, however, such issues that may arise during the initial phase of the changeover to IFRS are only temporary in nature and by no means outweigh the long-term benefits of an accounting regime which is both more harmonised and better reflects the underlying risks that an individual firm is exposed to. The application of the new accounting rules across individual institutions in different Member States clearly benefits cross-country comparisons and aggregation, which in turn results in cross-country macro-prudential indicators that are more meaningful in the longer term.