

IFRS: A REVIEW OF ISSUES LIKELY TO IMPACT ON MFSD'S DATA - 2008 UPDATE

The Bank would welcome approaches from any reporter for whom the development of new IFRS-based information systems may impact on their ability or preference to deliver statistical data on the current definitions. The Bank expects to issue updated guidance in due course but currently seeks more information on the nature, extent and timing of such reporting issues. Feedback is invited, either via the BBA/BSA or direct to the Bank. Where appropriate, the Bank will be pleased to meet with reporters to discuss specific difficulties.

Background

In 2004, the Bank met with bank and building society representatives to consider the potential impact on statistical source data due to the prospective move to IFRS-based financial reporting by some institutions. At that stage, individual institutions were intending to use macro adjustments at a portfolio level in their IFRS-based statutory financial reporting. Consequently, reporters at the time favoured retaining the existing statistical guidance until any new fully integrated IFRS-based management systems had been developed (see Statistical Notice 2004/06).

Over time, more reporters have developed or have been developing systems which might favour the delivery of statistical returns on an IFRS basis. We posted an updated set of guidance in 2006; the current text incorporates further revisions, reflecting our regular meetings with industry representatives and bilateral discussions with individual reporters during 2007 and 2008. A number of reporters are now in a position to complete statistical returns on a full IFRS basis, while others have begun exploratory discussions to inform the direction of their own system development plans.

An updated inventory of IFRS issues for statistical reporting

The following inventory broadly follows the sequence of 2004 Statistical Notice. It gives a quick outline of the issue, with an assessment of the impact for statistical guidance. Those items thought most likely to carry potentially important implications for reported data are marked with an asterisk. The list is not viewed as exhaustive, so readers are invited to indicate where additional topics should be included.

***1. Interest Recognition and Measurement**

***1.1 Interest recognition and the effective yield concept**

Some items which we currently classify as arrangement or similar fees associated with loans or deposits would, under IFRS, be absorbed within the computed interest series.

More formally, the IFRS standard for interest measurement uses an ‘effective yield’ concept which amortises all incremental transaction costs and any fees and expenses that are integral to the return on the instrument, over its expected life and, similarly, amortises any discounted or premium rates applied for the calculation of interest receipts or payments. (See IAS 18 and IAS 39)

There is a similar concept within IFRS17 (Leases), which requires initial direct costs charged by the lessor to be capitalised and thereafter amortised over the life of the lease.

Assessment

For the present, for form ER we require reporters to continue reporting interest on the pre-IFRS basis. Although the IFRS effective yield measure receives broad support from users, this support is conditional on all reporters being able to the change – mixed reporting with some reporters using the IFRS and some the UK GAAP measure would reduce the usefulness of the data for monetary policy purposes. And when the issue was last discussed with banking industry representatives in late 2007, a majority of banks preferred to continue to report under the existing statistical guidance.

***1.2 Interest on Impaired Assets**

Under IFRS, the interest recorded as accruing on an impaired loan may be lower than the contractual obligation currently required by statistical standards (ESA) because it is written down proportionately to the write down in the value of the impaired asset. (see IAS39 AG93)

Under ESA interest accrues on all loans (including those in arrears) based on the contractual rate (ESA does not currently require the separate recognition of impaired loans). Only after a loan is written off does accrual cease.

Assessment

We cannot accept a move to IFRS reporting on this as the IFRS methodology is not compatible with the international statistical standards. The statistical treatment of non-performing loans was reviewed within the current SNA review process, the majority favoured retaining current standards but with information on the volume and value of non-performing loans to be presented as memorandum items. The forthcoming ESA update is expected to follow this line.

*1.3 Designation of Accrued Interest

Under MFSD's statistical guidance, interest accrued on deposits and loans are initially reported within BT items 19CC and 35C and 35D, and only appear within the parent instrument lines from the relevant contract date. This treatment is in line with the Statutory Instrument governing the definition of Eligible Liabilities, used for the calculation of Cash Ratio Deposits (CRDs) which says, in relation to sterling deposits, "any interest which has accrued but has not yet been credited to an account shall be ignored".

Under IFRS, interest should accrue continuously within the parent instrument so that reported positions in these instruments are on average higher than under MFSD statistical guidance.

Assessment

The CRD Statutory Instrument excludes accrued interest from its definition of eligible liabilities; in order to comply with this, accruals have to be separately available to allow the required calculation of Eligible Liabilities.

This is an area where current MFSD statistical guidance is permitted under ESA but is not the preferred treatment, which is in line with IFRS. It is possible that the IFRS treatment could become the European statistical standard from 2011 (implementation would then be no later than 2014). If any reporters are keen to move to IFRS-consistent reporting, they should approach MFSD for a discussion of the issues.

*2. Netting And Rights Of Offset

IAS 32 sets stricter criteria for offsetting assets and liabilities than those currently permitted for statistical reporting and CRD calculation, offering the potential for balance sheets to be inflated. Netting under IFRS will only be permitted when both (a) the right to settle net and (b) the intention to settle net, or simultaneously, are present.

Assessment

MFSD is content with its current statistical guidance on netting, which is mirrored in the Statutory Instrument governing the definition of Eligible Liabilities for CRD purposes, but considers that the stricter rules implied by IFRS would also be consistent with international statistical standards. Any reporter wishing to change to an IFRS basis should contact MFSD.

3. *SPVs and securitisations

The movement of assets (and associated liabilities) between the balance sheets of reporters and securitisation vehicles has become an issue in the context of defining broad money and credit.

Assessment

The stricter rules on derecognition under IFRS have led a number of reporters to seek to bring back on balance sheet assets previously assigned to an SPV and reported separately. It is important that reporters discuss their proposed treatment of securitised assets with MFSD and should always seek guidance before changing the treatment of an existing securitisation.

Statistical standards focus on the status of the SPV – specifically whether it operates with sufficient independence from its parent to permit it to be recorded as a separate institutional unit. MFSD has actively sought to influence the wording of the new SNA in this area and believes that IFRS and future statistical standards should be broadly consistent. Discussions are still proceeding between the BBA and the Bank on UK practice while the draft of the new ESA chapter dealing with this topic has still to be considered and finalised.

4. Financial Derivatives

4.1 Valuation of Derivatives

IAS 39 rules on balance sheet valuation carry important implications for the recording of derivative instruments – requiring market or fair valuation in most circumstances.

Assessment

Statistical reporting should already be on this basis so it is not expected that IFRS implementation should give rise to any material data changes.

4.2 Cash Flow Hedges

IAS 39, Paragraph 95, Section (a) states, “the portion of the gain or loss on the (Cash Flow) hedging instrument that is determined to be an effective hedge...shall be recognised directly in the equity through the statement of changes in the equity...”

Assessment

We may need to seek further clarification on this issue but provisionally we doubt that the IFRS cash flow hedging treatments raise any new or additional difficulties.

Statistical standards apply common valuation and accounting treatments to instruments irrespective of the purpose for which the instrument is held. In the context of cash flow hedges, the partitioning of the valuation change in the derivative into effective and ineffective components, and the different treatment of these two elements, appears to breach this

principle. In practice, the specific issue here may be part of a more general difference of treatment between financial reporting and statistical systems. While the former may recognise holding gains and losses within the income statement, leading to profit and loss, such movements, whether realised or unrealised, are excluded from the statistical (National Accounts) notion of profit which derives from the value added concept. These differences are ones with which we are already dealing.

*4.3 Embedded Derivatives

IAS 39 considers the valuation treatment of complex financial products which include derivative elements. Where the derivative and the underlying instrument are not closely linked economically, then IAS 39 requires either the separation and fair valuation of the derivative or the fair valuation of the structured product with the derivative included. Where the derivative is closely linked to the underlying instrument, IAS 39 prohibits the separation and fair valuation of the derivative. In this case IAS 39 permits fair valuation of the entire product but does not require it.

Assessment

MFSD requires all deposit and loan data to be reported at nominal value for statistical purposes. If some deposit or loan products were to be fair valued because of the presence of an embedded derivative this could carry adverse implications for the monetary statistics.

In practice, while banks are likely to implement IFRS guidance on embedded derivatives at source, structured products of this type are thought to be rare and the impact on monetary aggregates minimal. If this assumption holds, then MFSD could be flexible with reporters while retaining the overall guidance on the reporting of loans and deposits at nominal value.

*5. Financial Guarantees

IAS 39 extends balance sheet recognition to cover certain forms of financial guarantee, regarded as off balance sheet under UK GAAP.

Assessment

Statistical standards are set to move in the direction of IFRS. For a number of years, this has been an aspect of IFRS which banks generally favoured including within statistical reporting; we do now permit certain types of financial guarantees to be reported within our balance sheet reporting. As part of this change, the reporting of all credit derivative products on Form DQ became effective from the end of 2007.

The revised SNA will recognise only certain forms of financial guarantee. Specifically, guarantees traded in financial markets (credit derivatives) are to be recognised and recorded as derivatives, and standardised guarantees are also to be recognised and recorded within insurance technical reserves. Non-standard one off guarantees, such as those sometimes

provided by governments to facilitate the raising of private funds by an agency established by but outside of government, will continue to be regarded as off balance sheet contingent instruments.

***6. Balance Sheet Valuation**

***6.1 General Guidance**

Under IAS 39 financial assets/liabilities are divided into four categories - financial assets/liabilities at fair value through profit and loss (comprised of held for trading, and assets to which the fair value option has been applied); held to maturity investments; loans and other receivables; and available for sale financial assets. One effect of this change should be to increase the share of the balance sheet subject to market or fair value recording.

Assessment

Loans and deposits must be reported at nominal value in order for us to preserve the coherence of the money and credit data.

Statistical standards require that all traded instruments, assets and liabilities, be presented at market value with non-traded instruments – principally loans and deposits – presented at nominal value. The new IFRS guidance accordingly appears generally closer to the statistical standard than did UK GAAP. IAS 39 states that loans will normally be reported at amortised cost but specifies circumstances in which fair valuation is required or permitted. The presence of an embedded derivative provides one such circumstance (see 4.3 above) but other possibilities might exist.

***6.2 Valuation of FDI**

IFRS requires FDI to be valued on either an historic cost or fair value basis. This appears to differ from the net asset or book value bases on which MFSD understands banks' current reporting to be based.

Assessment

This is a complicated area, and we are keen to explore with reporters their methods of valuation and the scope for alternatives to historic cost measures. Our preference – as we state in the reporting guidance for the HI/HO forms – is at the value standing in the books of the reporting institution (ie book value).

Some reporters have suggested that moving from UK GAAP to IFRS will change the basis of their valuation of unlisted subsidiaries from net asset value to historic cost, because they favour the historic cost option over the fair value option. This would move us away from the “Own Funds at Book Value” valuation method that is being considered for new statistical standards and is the preferred approach for the forthcoming IMF Coordinated Direct Investment Survey.

7. Classification of Debt and Equity Liabilities

IAS 32 changed the way in which certain items are classified as debt or equity to ensure definitions of instruments were brought more closely into line with their economic characteristics. For example redeemable preference shares moved from being equity, under UK GAAP, to a debt liability under IFRS - there is also an interest expense under IFRS. Similarly, Reserve Capital Instruments also changed treatment; from being included in undated loan capital under UK GAAP to be part of equity as 'other shareholders' interests' under IAS 32 they (considered to be more in line with economic characteristics than the previous treatment).

Assessment

In principle MFSD has accepted these changes for statistical reporting; but in practice we retain the right to resist any reclassifications within statistical reporting where the change would adversely affect the resulting statistics.

8. Software Development

IAS 38 changed the classification of staff costs associated with in-house software development from a current to a capital expense.

Assessment

MFSD considered the IFRS treatment to be consistent with statistical standards. We accordingly indicated that those staff costs affected by this change of treatment should be removed from operating expenses – item 12 on form PL – and be recorded instead as acquisitions of intangibles within section 6 of form QX.

No further transitional effects are anticipated.

9. Accounting for Pensions

IFRS implementation brought pension accounting into the profit and loss account, and on to the balance sheet.

Assessment

MFSD set out the reporting treatment in Statistical Notice 2005/02. In summary, the liability for pension obligations recognised under IFRS should be reported on the Form BT in item 19CD – “Capital and other internal accounts”. The accrued pension payments recognised under IFRS as Current service cost, Past service cost, Losses on curtailment and Net actuarial losses recognised during the year should be included in item PL12AB – operating expenses – pension contribution.

No additional issues expected as a result of moves to bottom up IFRS reporting.

10. Dormant Accounts

Under IFRS, deposits which had been deemed dormant, and taken to profit, may have to be restated as deposits.

Assessment

Reporters have asked about this and an FAQ was issued in 2005. In summary, dormant accounts will need to be reported on the BT, BE and AD in the same way as all other deposit accounts. The Bank will need to be informed of the amounts involved and their sectorisation preferably before the amounts are added to the balance sheet.