



# IFRS® Standards and financial stability

The views expressed in this presentation are those of the presenter, not necessarily those of the International Accounting Standards Board (Board) or IFRS Foundation.

Since the Global Financial Crisis there is increased focus on the interaction between financial stability and IFRS Standards

This is primarily relevant for financial institutions, which are most susceptible to accounting volatility

The IFRS Foundation and prudential regulators see transparency as a key element of financial stability

Recent changes to accounting for financial instruments and insurance contracts will greatly contribute to transparency and comparability

## Mission Statement

‘Our mission is to develop IFRS that brings transparency, accountability and efficiency to financial markets around the world. Our work serves the public interest *by fostering trust, growth and long-term financial stability within the global economy*’

1 *'Fostering financial stability is not the primary goal of accounting standards; this is primarily the remit of prudential regulators, whose task it is to safeguard the solvency of the financial system'*

2 *'The transparency provided by accounting standards can in the short run even lead to instability as problems buried deep within a company's balance sheet are brought to light'*

3 *'However, problems can best be addressed if they are first made visible by high quality accounting'*

4 *'That is why we believe that the transparency provided by high quality accounting standards is indispensable for, and contributes to, long-term financial stability'*

## Accounting transparency

- Gives stakeholders timely information to enable them to take action
- Discourages management from taking unnecessary risks
- Supports informed decision-making



Hence promotes financial stability



# Accounting volatility and its effects on financial stability

# 'Traditional' accounting and the revisions to prudence

## Traditional accounting

Deferral, matching and “prudence” could give rise to excessive smoothing



This would reduce volatility but also reduce transparency

## The Board's revised definition of prudence<sup>(1)</sup>

It does not allow:

- understatement of assets and income; or
- overstatement of liabilities and expenses



It will help deliver greater discipline in profit recognition

(1) In the Conceptual Framework for Financial Reporting

## Specific challenges for banks and insurers

### Very large balance sheets

- Financial assets and liabilities not perfectly matched economically
- High leverage gives rise to volatility

### Manage financial risks for clients

- Volatility reduces clients' trust in the business

### Reliance on public confidence

- Banks in particular are inherently unstable and susceptible to 'runs' even when technically solvent





# Financial stability and IFRS 9

# Expected credit loss (ECL) provisions

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Previous  
impairment  
requirements  
(IAS 39)

- Incurred loss provisions were ‘too little too late’
- Criticised by regulators and the G20

New  
impairment  
requirements  
(IFRS 9)

- ECL is forward-looking and provides timely information about changes in credit risk
- ECL recognised from inception, with full (lifetime) provisions when assets underperform
- Disclosures to support ECL provisions provide more transparency about lending practice and managements’ assumptions

# ECL—contrasting views

## Views of some

- ECL is too complex and subjective
- Provisions are volatile and made too early
- The model is procyclical



## Regulators' view (BIS)<sup>1</sup>

- Prompt loss recognition reduces procyclicality
- ECL provisioning will improve banks' risk management practices
- Provisions that better reflect risk will improve credit risk management and pricing

<sup>1</sup> Bank for International Settlements (BIS)

IFRS 9 removes Available for Sale (AFS) category for equity investments<sup>1</sup>



Fair value information is usually reported in profit or loss

## Critics

- Fair value does not reflect the long-term nature of the investment

## Board's conclusion

- AFS accounting
  - enabled recognition of losses to be delayed, which increased procyclicality and distorted measures of performance
  - artificially linked gain recognition in one period in profit or loss to disposal
- The change in IFRS 9 improves transparency and so aids decision-making

<sup>1</sup> Under IAS 39, assets in the AFS category were at fair value on the balance sheet but changes in value were taken to Other Comprehensive Income and recognised in profit or loss if the investment was impaired or the investment was sold.



# Financial stability and IFRS 17

IFRS 17 will contribute to financial stability through

Better and more consistent accounting for liabilities



- Increase understanding of insurance risks
- Greatly enhance comparability

Consistent principles for recognition of revenue and profit consistent with other industries



- Increase understanding of insurers' financial performance and greater comparability with other industries

Greater transparency and lower cost of capital



- Promote market discipline
- Improved basis for capital allocation

Insurance liabilities properly measured

Transparent costs of options and guarantees

Updated information on risk margins

Immediate recognition of onerous contracts

Ends up-front profit taking

Better information on profitability trends

## Insurers' concerns about volatility

- As IFRS 17 has developed the Board has taken steps to address most insurers' concerns
- Details are available in the Feedback Statement on IFRS 17 published in May 2017

## Unresolved insurers' concerns

- Centred on possible accounting mismatches and the level of aggregation applied to insurance contract portfolios
- The Board balanced addressing concerns with quality of information for users of financial statements





# Financial stability and prudential regulators

- Prudential regulators increasingly see transparency as a key element of market discipline for financial institutions

ECL model under IFRS 9



Improved accounting for insurance contracts under IFRS 17<sup>1</sup>



**Improve information about risks that financial institutions face and hence enhance market discipline**

- There will be circumstances where disclosures could adversely affect confidence and so damage financial stability, but these should be rarer as the risks of banks being ‘too big to fail’ reduce

<sup>1</sup> The Financial Stability Board formally welcomed the publication of IFRS 17 in a Statement published on 17 July 2017

## How do regulators see changes introduced by new Standards?

They see measures of assets and liabilities provided by IFRS 9 and IFRS 17 as a better basis for measures of capital adequacy as well as providing better information for stakeholders

## What will regulators do?

They can and do adjust the measures of capital for effects of accounting standards to deliver prudential capital that can absorb losses

They will also develop rules to address the effects of accounting volatility on capital rather than seek to conceal the volatility

## The Foundation's role

- Supporting financial stability by ensuring that information is
  - provided on a timely basis; and
  - explained and understood

## The Foundation's work with regulators

- Working with prudential regulators as they develop guidance and requirements on
  - the interaction between accounting and regulatory measures of capital; and
  - enhanced risk disclosures

This is consistent with the Foundation's Mission statement and our commitment to Standards that foster financial stability