IFRS® Standards and financial stability

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Overview

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.
How do IFRS Standards contribute to financial stability?

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’
‘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’

‘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’

‘However, problems can best be addressed if they are first made visible by high quality accounting’

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

Transparency and 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

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
Financial stability for financial institutions

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

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)¹

- 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

¹ Bank for International Settlements (BIS)
Equity investments

IFRS 9 removes Available for Sale (AFS) category for equity investments

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

1 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
Accounting volatility and insurance contracts

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
IFRS 17 and stability

- 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
Issues raised by insurers

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
Transparency and financial stability

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

- 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

ECL model under IFRS 9

Improved accounting for insurance contracts under IFRS 17

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

1 The Financial Stability Board formally welcomed the publication of IFRS 17 in a Statement published on 17 July 2017
Capital adequacy implications

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 work with regulators

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