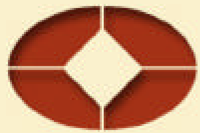

Accounting for Banking and Insurance – Survival in an IFRS World

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What we're going to cover today

- Accounting for financial intermediaries
- A brief history of IFRS development
- Financial statement asymmetry – why investors and other users can't see the whole picture
- The role of risk and risk management disclosure in financial statements
- Assessing position and performance from a regulator's perspective -- does GAAP matter?
- Policing the margin in a bancassurance environment

A tale of two accounting philosophies….

Accrual, or historical cost

AND

Fair value

Does accrual accounting tell the full story?

- Traditional manufacturing and commercial activities are well served by this model
- Assets valued at cost until sold
- Revenue recognised only when earned through sales
- Current costs matched against current revenues in income
- Pre-recognised revenues and costs “aged” on the balance sheet until proper time to be recognised in income
- Any other gains and losses recognised on cash basis

Does accrual accounting tell the full story?

- Not necessarily the case for financial intermediaries
- Any risk-based activity has the potential to generate both realised and unrealised gains and losses
- Need to capture minute-to-minute risk management results
- Accrual-based accounting for financial intermediaries focuses on capturing realised gains, all losses
- Adequate for “hold to maturity” loans, investments and deposits
- Model largely consistent with regulatory views

Does accrual accounting tell the full story?

BUT

- Built-in incentives to “cherry-pick” asset sales to manage earnings
- May not deal appropriately with non-cash instruments such as derivatives

Does fair value accounting work any better for financial intermediaries?

- Some would say “yes” very enthusiastically
  - looks forward rather than back
  - highly transparent
- Others would say “yes, but not now” because:
  - ability to reliably estimate fair values is suspect
  - goal of perfect symmetry includes counterintuitive results
  - road to this goal has other blockages
- Many simply say “not ever!” because:
  - model will produce more volatile financial statements

Does fair value accounting work any better for financial intermediaries?

HOWEVER

- Many have said “not ever!” because:
  - model will produce more volatile financial statements
  - relevance to “held to maturity” activities is suspect

Accounting for financial intermediaries: should industry matter?

- Just how different are banking and insurance?
  - asset versus liability focus?
  - intermediation versus servicing?
  - robustness of secondary markets?

Asset versus liability focus?

- Banking is “asset driven”
- Insurance is “liability driven”
- Difference of emphasis reflects traditional business risk focus and management expertise

BUT

- Increasingly, other financial risks affect both enterprises and require same risk management attention

Intermediation versus servicing: Banks?

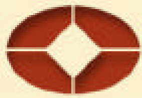
- Banks viewed primarily as intermediaries, but markets have been shifting:
  - decline of the "traditional depositor"
  - rise of the "retail investor"
  - increasing reliance on fee-based over spread-based business
  - evolution of the capital markets:
    - own risk protection
    - "matchmaking"
    - active trading

Intermediation versus servicing: Insurers?

- Life insurers no longer just protectors/service providers:
  - whole life not the only way to replace capital, income
  - new product development and life cycles based on demographics and demographic shifts
  - legal form and license to purvey losing relevance
  - the role of market deregulation
- General insurers
  - still a separate breed, but
  - managing portfolio risk is no longer someone else's problem

Robustness of secondary markets: Traditional banking?

- Retail and wholesale banking not dependent on active secondary markets to manage or value business risk
- Two traditional risks – credit and interest rate
- Adequate (but barely) with accrual accounting system because:
  - Credit risks visible only once deterioration identified
  - Interest rate risks largely invisible unless impacts are significant and materialise rapidly



Robustness of secondary markets: Bank capital markets?

- More products dependent on active secondary markets to manage and value risks
- More risks unseen, potentially fatal if not identified, recorded, measured and managed carefully
- Development of derivatives
- Mitigate own risk ? mitigate others’ risks ? trade
- Not always well served by accrual accounting system

Robustness of secondary markets: Insurance risk?

Insurance:

- Traditional risk redistribution through reinsurance
- Highly cyclical, uncertain liquidity, unique value drivers
- Recent redistribution experiments through capital markets
- Also poor fit with accrual accounting model

BUT

- Markets insufficient to support market-based fair value accounting either!

Robustness of secondary markets: Other insurer risks?

Please refer to discussion of banking risks!

Accounting for banks – summary of key elements

- Pre-IFRS world primarily accruals based
- Spread income recognised smoothly over time
- Loan losses recognised per regulatory requirements
- Trading income either on market or LOCOM
- Fee income largely upfront
- Trading derivatives at market, hedging derivatives at cost
- Results:
  - stable balance sheet, conservative values
  - appearance of stable margins, some volatility in earnings and capital from fees and trading activities

Accounting for insurers – summary of key elements

- Pre-IFRS world shaped by insurance regulators
- Assets maintained on cost basis, liabilities held at required prudential levels, with few exceptions
- Income deferrals or smoothing devices common
- Result:
  - balance sheet combining accrual and solvency-based approaches, little book capital
  - stable, very conservative earnings

Checkpoint: what have we seen so far and what should we conclude?

- Accrual accounting not designed with financial intermediaries in mind, but has been adapted
- Many regulators and some markets still content with this model
- Product and risk management evolution placing pressure on this model
- Fair value alternative is attractive, but not without problems
- Ideal accounting model for financial intermediaries should focus on common elements, not industries

A brief history of IFRS development

International standards are not new – over 30 years not new!

- Original focus:
  - “bottom-up” harmonisation of existing standards,
  - identification and promotion of best alternatives without shutting down others, to promote usage
  - “Inclusiveness” over expertise, with impacts on group composition and focus

A brief history of IFRS development

- Catalysts for change:
  - 1980's: rapid product and market evolution; higher risks, more rapid risk transmission capability
  - 1990's: market meltdowns; global regulators looking for causes see international standards as possible cure
  - 2002: Europe's decision to use IFRS

A brief history of IFRS development

- Regulatory endorsement with conditions:
  - elimination of less appropriate alternatives in favour of best prevailing standards (IOSCO – 2000)
  - fix IAS 39 on recognition and measurement of financial instruments and enhance IAS 39 on bank disclosures (BCBS – 2000)
  - develop a high quality model for insurance liabilities (IAIS – 2000)
  - resolve disconnects discovered between accounting and business models (EC – 2004)

A brief history of IFRS development

- Initial impacts:
  - 1999: Identification of international accounting standards as potential cure
  - 2001: Transformation of group (IASC ? IASB) and group mandate (top down, focus on expertise and leadership)
  - 2001: Trial balloon paper on full fair value model
  - 2001 – 2002: busy progress toward goals identified by IOSCO and prudential regulators

A brief history of IFRS development

- More recent impacts:
  - 2002: Norwalk Agreement on convergence between IASB and FASB
  - 2002-2003: IASB shocked at global pushback on IAS 39, 32 and insurance projects; forced into phasing in insurance, modifying hedging and fair value approaches
  - March 2004: “Stable platform” for Europe 2005 implementation, but fair value option and hedging still uncertain
  - July 2004: European endorsement of IAS 39????

Financial statement asymmetry – why investors and other users can’t see the whole picture

- IAS 39 and IFRS = “mixed” measurement model for financial instruments including insurance liabilities

- Primary rule = related cash assets, cash liabilities and derivatives measured under separate and often different rules

Financial statement asymmetry – why investors and other users can't see the whole picture

- Any measurement imbalances not reflecting underlying risk positions fixable in one of four ways:
  - qualify for original hedge accounting (very hard to access, very complex to use)
  - use macrohedge accounting for IRR (of limited usefulness to operations funded by core deposits)
  - use the "shadow accounting" option under IFRS 4 (available to insurers, but of limited usefulness)
  - use the fair value option (open to all, easier to access and operate, but some restrictions limit usefulness)

Financial statement asymmetry – why investors and other users can't see the whole picture

- Result?
  - Many economically sound hedging strategies will be misrepresented because of IAS 39 measurement rules
  - Financial statements will appear more volatile than they really are

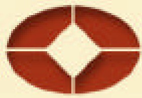
Financial statement asymmetry – why investors and other users can't see the whole picture

- What choices do financial intermediaries have?
  - take full (and costly) advantage of whatever relief exists under the four alternatives and explain away the rest through extensive (and expensive) disclosure

    OR

  - don't hedge risks at all if the books look more stable that way!

(Note: regulators might be just a little worried about #2!)



Financial statement asymmetry – why investors and other users can't see the whole picture

- Mixed asset rules:
  - trading at fair value, gains/losses to income
  - "available for sale" (could be sold one day), at fair value, with gains/losses direct to a component of equity (exception: identified impairment losses to income)
  - held to maturity securities (will be held to the end) at amortised cost
  - loans and receivables at amortised cost
  - Fair value option: same as for trading

Financial statement asymmetry – why investors and other users can't see the whole picture

- Mixed liability rules:
  - trading at fair value, gains/losses to income
  - no "available for sale" category for bank liabilities
  - deposits and subordinated debt at amortised cost
  - insurance liabilities, national rules (usually but not always amortised cost) with possibility to use "shadow accounting" (results similar to available-for-sale)
  - Fair value option: same as for trading, except for "deposit floor" concept

Financial statement asymmetry – why investors and other users can't see the whole picture

- And we can't forget derivatives!
  - Always fair valued
  - Gains and losses always to income, unless part of a qualified hedge accounting arrangement

Financial statement asymmetry – why investors and other users can't see the whole picture

- Example #1: hedging interest rate risk in banking book
  - Loans and deposits "matched" at cost
  - Interest rate risk being economically hedged by derivatives that must be fair valued

- Possible outcomes:
  - Non-qualifying derivatives create fair value gains and losses in income
  - Qualifying derivatives still create fair value gains and losses in capital

Financial statement asymmetry – why investors and other users can't see the whole picture

- Example #2: hedging interest rate risk in banking book
  - Debt securities funded by deposits
- Possible outcomes:
  - No issues if securities meet held to maturity criteria and do not trigger "tainting" rules due to early sale
  - Securities not meeting criteria classified as available for sale, fair valued, with latent gains and losses taken to equity

Financial statement asymmetry – why investors and other users can't see the whole picture

- Example #3: Loans hedged with a credit derivative
  - credit derivative with several triggers used to hedge risk of credit risk deterioration in a group of loans
- Outcome:
  - credit derivative not eligible for hedge accounting treatment, fair value gains and losses to income
  - loan portfolio assessed separately for impairment
  - offsetting gains and losses measured differently and may appear in income at different times

Financial statement asymmetry – why investors and other users can't see the whole picture

- Example #4: On occasion, unmatured debt securities must be sold from an insurer's portfolio to meet maturing policy obligations. No IAS 39 hedging rules can be used.
- Possible outcomes:
  - assets at fair value with gains and losses to equity, plus liabilities at amortised cost (asymmetry)
  - as above, but with shadow accounting (asymmetry reduced)
  - assets and liabilities use the fair value option (asymmetry where liabilities cannot be held below redemption value)

Financial statement asymmetry – why investors and other users can't see the whole picture

- Does macrohedging help?
- Yes and no.
  - portfolio hedging for banks works well so long as net liability exposures have similar contractual and effective durations
  - does not work for "core deposits" because material disparities between contractual and behavioural maturities are not recognised under IAS 39
- Insurance equivalent raised in example #4 under fair value option will be a problem in Phase 2 and impede adoption of full fair value later on if not resolved.

The role of risk and risk management disclosure in financial statements

- Regulators have taken a lead role in promoting more risk disclosures in financial statements
  - BCBS development of Pillar 3 requirements as a direct incentive to banks to improve disclosure practices
  - July 2004 IASB Exposure Draft on Financial Instruments Disclosures a direct result of BCBS endorsement, including influence of Pillar 3
  - IAIS has also developed robust guidance on disclosure and provided input to the IASB

The role of risk and risk management disclosure in financial statements

- Primary focus is to promote a clear and comprehensive understanding of an institution's risk culture, policies, practices and outcomes.
- In view of the shortcomings of IAS 39 and IFRS 4, disclosure serves a very important secondary purpose: to set the record straight!
- Equity analysts are not dimwits, but they need information to come to the right conclusions. Only ratings agencies can ask when no one else is listening.
- Institutions that do not put the right messages into the market will be penalised by the markets.

Assessing position and performance from a regulator's perspective – does GAAP matter?

- The short answer is, it should!
- External reporting, management reporting and regulatory reporting are three variations on one set of financial facts and circumstances.
- Messages to all three audiences need to be consistent if each audience is to make its decisions appropriately.
- In many jurisdictions, the only information subject to external audit is based on GAAP and related to what is said to the marketplace.
- Communication with institutions and between regulatory agencies can be facilitated by using a common language.

Assessing position and performance from a regulator's perspective – does GAAP matter?

- Regulators are not that different from other stakeholders in terms of their ongoing information needs.

- Where needs diverge, regulators are fully in charge of what happens from that point.

Assessing position and performance from a regulator's perspective – does GAAP matter?

- On an ongoing basis, regulators are interested in:
  - Quality and mix of:
    - assets
    - liabilities
    - capital
    - earnings
  - Trending
  - Benchmarking
- Properly configured, GAAP information provides the building blocks for position and performance assessment

Assessing position and performance from a regulator's perspective – does GAAP matter?

- Key difference from other stakeholders is the regulatory focus on capital – its sufficiency and robustness to absorb the unexpected, on the assumption that GAAP takes care of the expected.
- As noted before, GAAP has not caught up with the expected yet, so this continues to cause concerns within the regulatory community as well as more work than is needed to "bridge the gap".
- Ideal GAAP is not equal to regulatory reporting, but they need to be much closer than today.

Policing the margin in a bancassurance environment

- Financial services groups involved in both banking and insurance have special challenges, as do their regulators.
- In the longer term, expectations are that GAAP will evolve toward full fair value, including a final model for insurance liabilities.
- For now, risks lie in:
  - asymmetries within banking and insurance
  - asymmetries between banking and insurance
  - borderline uncertainties between bank and insurance
  - potential for accounting or capital arbitrage

Summary

- Accounting for financial intermediaries is moving toward a common reporting model
- Current IFRS is an awkward “halfway house”
- Sound disclosures will need to carry much of the reporting load until accounting evolves further
- As risk management experts, regulators have a major role to play
- Objective: financial reporting should reflect the outcomes of risk strategies, policies, management and outcomes.