



SOVEREIGN DEBT, THE EUROZONE CRISIS AND DERIVATIVE VALUATIONS

CHALLENGES FOR THE 2011 BANK REPORTING SEASON

This note briefly summarises the main areas of concern highlighted at the ICAEW Financial Services Faculty's Auditor-Investor Forum on 24 November 2011.

It presents areas that financial institutions, their auditors and users of financial reports may need to pay particular attention to in order to explain and understand the financial position of the institution concerned.

The discussion was held under the Chatham House Rule. Lead discussants provided introductory comments before the discussion was opened to other attendees, which included investors, auditors, analysts, regulators and preparers of financial statements. This note does not necessarily represent the views of ICAEW or any individuals present.

Ensure accounts tell the story

There remains scope in many banks' accounts to improve communication of the key drivers of the business, and its results, to stakeholders. This is true of information on risk generally, and liquidity in particular.

A risk statement?

It was suggested that the banking industry should develop an agreed approach to producing a statement on risk, which would bring greater transparency and focus to the key question of what risks are being taken in order to earn returns. Even if that were not done, there is scope to move existing risk disclosures in that direction. Trading was seen as a particularly opaque area, with little transparency around the nature and degree of risk represented by sometimes very large balance sheet values for trading assets and liabilities (including derivatives).

AUDITOR-INVESTOR FORUM

The **Auditor-Investor Forum** was established by the ICAEW Financial Services Faculty to promote dialogue between investors, auditors and preparers regarding the approach taken to the published accounts of financial services businesses, especially banks.

It was set up following the publication of the faculty's report *Audit of Banks: Lessons from the Crisis* in June 2010.

LEAD DISCUSSANTS

Mark Rhys, Forum Chairman,
Banking and Capital Markets Partner,
Deloitte and Chairman ICAEW
Financial Services Faculty

Jonathan Tyce, Senior Analyst, EMEA
Banks, Bloomberg Research

James Longsdon, Co-Head of EMEA
Bank Ratings, Fitch

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Liquidity

It is currently very difficult to discern from published accounts the approach taken by banks to liquidity management. There needs to be more information about how different classes of asset are funded. For example, a significant amount of very short-term funding is not necessarily a problem if it finances short maturity, or very liquid assets. Much more information could be provided on the extent to which assets are encumbered (for example, through sale and repurchase agreements or covered bond programmes), and also the level of assets which remain available for use as collateral.

There was agreement that the standard cash flow statement does not contain useful information for banks and that it would be better replaced by something along the lines of a statement on the sources and application of funds.

Provisioning against Eurozone exposures

Diversity of practice within and across jurisdictions may be inevitable given the scale of uncertainties about the future course of Eurozone economies, together with pressures from some governments and regulators. There will be adverse market reaction to provisions considered to be insufficient.

An important issue is judging the extent to which exposures to Eurozone countries should be regarded as mitigated by any Credit Default Swaps (CDS) held, given that any future sovereign debt write-downs may be structured so that technically they do not qualify as a default event to avoid triggering CDS payments.

Provisioning, however, remains a matter of judgement even in the most predictable situations. For example, assumptions about loss emergence periods are important in calculating provisions for retail and SME portfolios.

Measuring fair values

This continues to be challenging in the many markets characterised by features such as low liquidity and wide bid-offer spreads. It is important that the main judgements are clearly explained in accounts: this should not be confined just to assets classified as 'Level 3' in the fair value hierarchy.

Own credit risk

Most participants thought that reflecting the own-creditworthiness of a firm in the value of its liabilities generally did not provide useful information. It was important that the impact on net worth and profitability was clearly highlighted to users. The challenge of disentangling own-credit from other factors which affect the fair value of liabilities, such as movements in the yield curve, was noted.

Goodwill

Continental European banks still carry around €200bn of goodwill on their balance sheets. Analysts believe that much of this is impaired, bearing in mind that banking sector market capitalisation has fallen from around twice book value before the financial crisis to about a half currently. This means that banks' accounting net worth may be overstated – though there is no effect on regulatory capital, as goodwill is always deducted in arriving at that figure.

Differences between IFRS and US GAAP

Continuing differences impeded comparability between US and non-US firms. For banks with significant trading operations, the fact that IFRS is much more restrictive than US GAAP regarding netting of financial instrument positions is particularly significant.

Regulatory capital ratios

Ratios published by the larger banks, which use the internal ratings ('IRB') approach, were seen as lacking comparability and reliability. That reflects the use of models and judgements within the IRB approach to measuring exposures on a risk-weighted basis, in order to calculate risk-weighted assets which form the denominator of the regulatory capital ratio. The Basel Committee is aware of this issue, and is undertaking work to promote more comparable practice. However, scepticism was expressed about the efficacy of this, given the complexity of the IRB approach and of the banks which typically apply it.

It was agreed that users of accounts should be aware that published regulatory capital ratios are not subject to audit, though that in itself does not mean there is a problem with the quality of such data.