MARK PLAN AND EXAMINER'S COMMENTARY

The marking plan set out below was that used to mark this question. Markers were encouraged to use discretion and to award partial marks where a point was either not explained fully or made by implication. More marks were available than could be awarded for each requirement. This allowed credit to be given for a variety of valid points which were made by candidates.

Question 1 – Robinson Bank plc

Total Marks: 42

General comments

The candidate is placed in the role of an ICAEW Chartered Accountant working in strategic planning for Robinson Bank. There are two main areas of focus: the impact on Robinson's capital adequacy of a Department of Justice (DOJ) fine for mis-selling mortgage backed securities; and credit rating downgrades of investments held by Robinson.

The candidate must deal with the regulatory and financial reporting impact of these issues and evaluate three suggestions made by Robinson's risk committee to address the issues.

Robinson's statement of financial position with notes is provided in Exhibit 1 and regulatory information is provided in Exhibit 2. Information from Robinson's lending departments is provided in Exhibit 3 to give further details about the credit rating downgrades. Three suggestions from the risk committee are outlined in Exhibit 4.

1.1 a)

Calculation of total regulatory capital requirement and CET1 capital requirement

Risk weighted assets (RWA)			**£m**
Operational risk	14,244 x 15% = 2,137	x 12.5	26,708
Market risk	898	x 12.5	11,225
Credit risk			
- Internal ratings based (IRB)	170,582 x 2.6% = 4,435	x 12.5	55,439
- Standardised approach			22,341
Total RWA			**115,713**

Total capital requirement %	**%**
GSIB buffer	1.50
Capital conservation buffer	1.25
Countercyclical buffer	0.50
Individual capital guidance (ICG)	9.50
Total %	**12.75**

Total regulatory capital requirement = Total capital requirement % x total RWA
= 12.75% x £115,713m
= £14,753m

CET1 capital requirement %	**%**
Minimum CET1 capital	4.50
GSIB buffer	1.50
Capital conservation buffer	1.25
Countercyclical buffer	0.50
Pillar 2A: 56% of excess of ICG over 8% must be CET1 (56% x (9.5-8))	0.84
Total %	**8.59%**

CET1 capital requirement	=	CET1 capital requirement % x total RWA
	=	8.59% x £115,713m
	=	£9,939m

b) Calculation of Robinson's total regulatory capital and CET1 capital

Note: because there is no tier 2 capital in issue; tier 1 capital is equal to total regulatory capital.

	£m
Ordinary share capital	4,355
Share premium	4,888
Retained earnings (Note 1)	29,883
	39,126
Adjustments:	
Deferred tax asset	(6,342)
Goodwill and intangibles	(16,329)
Excess of expected loss over allowance for impairment (IRB approach to credit risk) (14,430-11,234)	(3,196)
Holding in Steel Bank	(2,345)
CET1 capital excluding investment in Steel	10,914
Add: Steel Bank adjustment (Note 2)	1,213
Total CET1 capital	**12,127**
Additional tier 1 capital	3,505
Total capital	**15,632**

Note 1: Current year profits should not be included unless externally verified. Without further information, the entire retained earnings figure is included.

Note 2: An adjustment is required for the holding in Steel Bank plc, despite it being an insignificant holding, as the holding exceeds 10% of Robinson's CET1 capital. The adjustment must reflect a deduction for the excess above 10% of Robinson's CET1 capital. This is achieved by deducting £2,345m and adding back the amount that does not exceed 10% of CET1 of £1,213m (10/90 x £10,914m)).

Robinson's capital ratios:

Total regulatory capital ratio	=	Total capital / total RWA
	=	15,632/115,713
	=	13.51%
CET1 capital ratio	=	CET1 capital / total RWA
	=	12,127/115,713
	=	10.48%

This indicates that as at 31 October 2017 Robinson satisfies the capital requirements for both total capital (12.75% minimum) and CET1 (8.59% minimum).

Examiner's comment

Candidates performed very well on this requirement, often gaining full marks.

The calculation of the regulatory capital requirements was answered well. The calculation of Robinson's own capital generated a wider range of answers.

Headroom marks were available and candidates who followed a methodical approach, followed through their own calculations and drew conclusions based thereon, gained good marks.

Common errors included: omitting to multiply the market risk capital requirement by 12.5 to calculate risk weighted assets; including both the Pillar 1 capital requirement of 8% and individual capital guidance of

9.5% in the total capital percentage whereas ICG includes the 8% plus the Pillar 2A buffer; and deducting the incorrect EL-P adjustment. A significant minority of candidates used the provision for the fine of £1,200 million instead of the impairment allowance of £11,234 million.

Adjustments for the deferred tax asset, and goodwill and intangibles were made accurately by all but the weakest candidates. Most candidates attempted the adjustment for the investment in Steel Bank which, although an insignificant holding (less than 10% of Steel's share capital), exceeded 10% of Robinson's CET1 capital. Credit was awarded for attempts to deal with this adjustment. Scripts where the investment was added rather than deducted did not gain marks.

A significant majority of candidates provided an evaluation of their calculations to conclude whether Robinson holds sufficient CET1 and total capital. Follow through marks were awarded.

Candidates must take care to read the requirement carefully because a significant minority of candidates provided explanations for the calculations. This was not required.

Total possible marks Maximum full marks	14 11

1.2

The settlement of the fine is likely to be between the £1,200 million already provided for and the £10,600 million cited by the Department of Justice (DOJ).

If the fine were settled today for the full amount of £10,600 million rather than the provided amount of £1,200 million, the impact of fine would be to reduce capital by £10,600m - £1,200m = **£9,400m.**

Adjusted total regulatory capital (15,632 – 9,400) = £6,232m
Adjusted total regulatory capital ratio (6,232/115,713) = 5.39%

Adjusted CET1 capital (12,127 – 9,400) = £2,727m
Adjusted CET1 capital ratio (2,727/115,713) = 2.36%

However, since the level of CET1 would fall below 7%, the trigger level on the coco bonds, the bonds will convert to equity in accordance with the terms of the instrument.

Therefore, the CET1 ratio would be the same as that calculated for total regulatory capital above of 5.39% as AT1 instruments would become equity.

This means that if the penalty of £10,600 million is levied, Robinson would fall below its regulatory capital minimums for both total capital and CET 1.

Robinson will need to report this matter urgently to the PRA because breaching the minimum capital requirements could mean that Robinson would no longer meet the threshold conditions of the PRA.

In the absence of a credible capital adequacy plan that is approved by the PRA, Robinson could face restrictions on its activities and ultimately face a prohibition on carrying out regulated activities.

Examiner's comment

The majority of candidates did not appreciate that a £1,200 million fine had already been recognised and therefore an adjustment of £9,400 was required. However, follow through marks were awarded for commenting upon the £10,600 fine in its entirety.

Candidates performed reasonably well on this requirement by explaining the impact of failing to meet minimum capital requirements and capital buffers.

Many candidates answered requirement 1.5 here by discussing the financial reporting impact of the fine. Marks were awarded accordingly.

Total possible marks Maximum full marks	7 6

1.3

These credit downgrades signal increased uncertainties around future expected cash flows which increases the probability of default and is reflected in higher risk weightings.

This would result in an increase in RWA as calculated below.

Commercial lending in Mediterranean countries

Amount of loans £m	Corporate risk weight 31 Oct 2017 %	RWA 31 Oct 2017 £m	Corporate risk weight 4 Dec 2017 %	RWA 4 Dec 2017 £m
22,307	20%	4,461	50%	11,154
30,102	50%	15,051	100%	30,102
9,239	100%	9,239	150%	13,859
		28,751		**55,115**

Wakanda loan

Amount (net of impairment allowance) £m	Sovereign risk weight 31 Oct 2017 %	RWA 31 Oct 2017 £m	Sovereign risk weight 4 Dec 2017 %	RWA 4 Dec 2017 £m
1,400	50%	700	150%	2,100

Total RWA at 31 October 2017 = £28,751m + £700m = £29,451m
Total RWA at 4 December 2017 = £55,115m + £2,100m = £57,215m

The increase in RWA due to the credit deteriorations is: £57,215m – £29,451m = £27,764 million.

This increase in RWA requires additional capital required as follows:

Total capital	£27,764m x 12.75%	=	£3,540m
CET1	£27,764m x 8.59%	=	£2,385m

Total regulatory capital ratio	=	Total capital / total RWA
	=	15,632/(115,713+27,764)
	=	10.90%
CET1 capital ratio	=	CET1 capital / total RWA
	=	12,127/(115,713+27,764)
	=	8.45%

The increase in RWA as a result of the credit deterioration results in Robinson not meeting its total regulatory capital minimum of 12.75% nor its CET1 minimum of 8.59%.

Examiner's comment

There was a wide range of answers provided to this requirement. Many candidates gained full marks by using the information in Exhibit 3 to calculate the impact of the credit rating downgrades on risk weighted assets (RWA).

Common errors included selecting the incorrect risk weight for corporate (commercial lending in Mediterranean countries) or sovereign (sovereign lending in Wakanda) exposures. Another common error was to mention only one of the lending types ie only commercial lending or only the Wakanda debt.

Marks were available for calculating and explaining the impact of the increased RWA on Robinson's capital adequacy. Revised total capital and CET1 capital adequacy ratios should have been calculated and follow through marks were awarded for appropriate conclusions.

Total possible marks Maximum full marks	9 8

1.4

Taking into account the credit deterioration, Robinson's RWA would be £27,764m + £115,713m = £143,477m

This would create capital minimums of:

Total capital	12.75% x 143,477 = £18,293m
CET1	8.59% x 143,477 = £12,325m

Using the figures from 1.2 for total capital and CET1 capital post DOJ fine, Robinson would face the following capital shortfalls:

Total capital	£18,293m – £6,232m = £12,061m
CET1	£12,325m – £6,232m = £6,093m

(CET1 is £6,232m as coco bonds would convert as trigger breached).

Robinson needs to raise more than £12,061 million of which at least £6,093 million must be CET1. To raise just these minimum amounts would be impractical since the bank must meet minimum capital at all times and needs some resilience against day-to-day variations in capital requirements.

The CET1 percentage of 8.59% will increase as the capital conservation buffer, GSIB buffer and countercyclical buffer are phased in over the next few years, Robinson must reflect this when raising new capital.

(1) Issue of new coco bonds

Issuing more coco bonds could create additional tier 1 capital (and contribute to the total capital requirement). However, reflecting the maximum amount of the fine, Robinson's CET1 capital has fallen to £2,727 million with a CET1 ratio of 2.36%. This is before reflecting the increase in RWA caused by the credit rating downgrades. Despite the conversion of existing coco bonds, the CET1 ratio remains below the 7% trigger point. Therefore, the new coco bonds would immediately convert into ordinary shares.

Holders of coco bonds would hedge against conversion by short selling ordinary shares which would have a negative impact on Robinson's share price.

(2) Rights issue

A rights issue of ordinary shares would provide an increase of CET1 that is necessary. Robin needs to raise a minimum of £6,093 million of CET1 and in practice would need to raise more to create a buffer above the regulatory minimum. A rights issue has the benefit of relative simplicity by avoiding the need to satisfy the legal requirements for a waiver of pre-emption rights.

Another benefit of a rights issue is that the currently depressed share price will not lead to the dilution of existing shareholders' ownership since they are the recipients of the offer.

The prospectus accompanying the rights issue will contain details of the expected fine and this may affect the demand for the shares. However, by ensuring that the issue is sufficiently discounted below the current share price it will be beneficial for shareholders to either take up their rights or sell them to other investors willing to buy at the offer price. The discounted rights price will impact the number of shares that must be issued to raise sufficient capital.

(3) Issue of subordinated debt

A private placement of subordinated debt, if structured to conform to the requirements of Basel, would constitute tier 2 capital. Tier 2 capital may be used to satisfy part of a bank's capital requirements due to its loss absorbing capacity prior to other creditors.

Although the systemic buffers under pillar 2 of Basel III must all be satisfied with CET1 capital, 25% of the pillar 1 minimum and pillar 2A buffer can be met with Tier 2 capital. This can be calculated as 2.375% (9.5% x 25%) x RWA.

Investors would be likely to accept a lower return from subordinated debt than coco bonds due to the lower risk of future cash flows not being received. Therefore, this represents an efficient way to satisfy part of Robinson's capital requirements. In addition, there would be no issue related to pre-emption rights as they do not apply to debt issues which simplifies issue procedures.

Conclusion

Given the nature of the potential capital shortfall the most efficient solution is unlikely to be the issue of a single form of capital. The issue of coco bonds as AT1 capital is unlikely to be sufficient to meet the capital needs and fails to address the shortfall in CET1 so some equity will need to be issued. The addition of tier 2 subordinated debt into the capital structure can represent an efficient way to meet a portion of the capital requirement and reduce the overall cost of capital.

Examiner's comment

This requirement involved application skills to identify the advantages and limitations of each of the risk committee's suggestions. This was a differentiator in the question between candidates' abilities. However, there were some answers which generated full marks to this requirement in scripts that performed very well on the paper as a whole.

A significant majority of candidates dealt with elements of this requirement very well by analysing how well each proposal would meet its objective and by discussing whether investors would buy coco bonds, take up the rights issue or invest in Robinson's debt, what costs would be involved and any other relevant factors.

A common error was misinterpreting the issue of subordinated debt. A significant majority of candidates treated this as an investment rather than an issue of debt ie raising funds.

Total possible marks	17
Maximum full marks	10

1.5

DOJ fine

The DOJ fine is likely to meet the definition of a provision under IAS 37 *Provisions, Contingent Liabilities and Contingent* Assets. There is a present obligation as a result of mis-selling MBS, which is a past event, a probable outflow of economic benefits will result from the DOJ fine and the best estimate of the amount is £10,600 million.

The DOJ initiated legal action on 24 November 2017 which is after the reporting date of 31 October 2017 and before the financial statements are authorised for issue. This is an adjusting event under IAS 10 *Events After the Reporting Period* because the fine provides more information about conditions existing on 31 October 2017 ie the possible fine related to prior mis-selling.

Further information should be sought regarding the existence of a legal obligation to pay the fine, if Robinson did mis-sell MBS. Legal advice should be sought around the likelihood of the DOJ action concluding with the fine payment. If the criteria are met, the amount of the fine should be amended to the best estimate and any difference taken to profit or loss.

Mediterranean credit downgrades

We need to consider whether the reduction in credit ratings could represent objective evidence of impairment. Credit downgrades alone do not represent this, particularly if the new rating is still investment grade.

We need to consider other evidence of impairment eg compare carrying amount to present value of future cash flows. If it is decided that an impairment event has occurred, there could be evidence of conditions existing at the year end.

If necessary, increase the allowance for impairment and reduce profit.

Wakanda debt credit downgrade

The credit downgrade relates to a specific unexpected event ie the change in government and temporary ban on payment of interest and repayments. This event occurred after the reporting date.

Therefore, even if the debt is now considered to have suffered further impairment, it is unlikely that an increased allowance for impairment would be an adjusting event for the 31 October 2017 financial statements.

Disclosure of the downgrade as a non-adjusting event would only be required if the amount is considered significant enough to affect the ability of users to make proper evaluations and decisions. In which case a description and estimate of financial impact is required.

Examiner's comment

The final requirement of question 1 was safe ground for many candidates and was generally answered well. However, a surprising number of candidates did not mention the events that took place after Robinson's reporting date, thereby missing out on available marks.

Also, the majority of candidates did not discuss the credit rating downgrades separately. There were clearly indicators of impairment in Wakanda but in Mediterranean countries further analysis was needed.

Total possible marks	9
Maximum full marks	7

Question 2 - Mariko

Total Marks: 33

General comments

The candidate is placed in the role of an audit senior working for Snook LLP on the external audit of the UK subsidiary of a Japanese bank. The subsidiary, Mariko, accepts deposits from UK customers and provides retail mortgages to UK customers.

Candidates are provided with draft financial statements and additional information about Mariko to enable them to identify risks related to the audit. The premise of the question is that the candidate assesses the subsidiary as a whole. There are two outstanding financial reporting issues relating to impairments.

Ethics is tested in this question through the audit senior and the audit firm having mortgages with the audit client.

2.1

Net interest income

Net interest income has increased from £210 million to £239 million, a 14% increase. The cost of funding (interest expense) as a percentage of interest income has reduced from 23% in 2016 (63 / 273) to 20% in 2017 (61 / 300). This is likely to be caused by the zero Japanese base rate reducing the cost of funding from Mariko's Japanese parent. However, a large proportion of funding is provided by personal and business customers' deposits. The returns on this funding are unlikely to have changed given the stable UK base rate so there is a risk that interest expense may be understated resulting in an overstatement of net interest income.

Debt securities as a proportion of total liabilities has increased to 15.7% in 2017 (1,200/7,625) from 12.1% in 2016 (700/5,794). Debt securities issued will attract a higher rate of return than deposits, so this further implies that interest expense may be understated.

Interest income is expected to increase because of growth in the mortgage book. To calculate the gross or net interest margin the average loans and advances balances should be used but, in the absence of this data, the year end balances may be used as an approximation.

The net interest margin in 2017 is 2.8% (239 / (254+8,230)). The 2016 figure is 3.3% (210 / (310+6,120)). It is concerning that the margin has fallen despite an increase in the loan book. There is a risk that Mariko is accepting new business that is not as profitable as existing business.

Gross interest margin shows a similar pattern falling from 4.3% (273/(310+6,120) in 2016 to 3.5% (300/(254+8,230) in 2017.

There is also a risk that the revenue recognition policy may be inappropriate eg the application of the effective interest rate method.

Administrative expenses

Administrative expenses have increased by 26% ((101/80) - 1) since 2016. This is caused by the investment in digital offerings and should result in cost savings in the future. A cut-off risk relating to these expenses may exist and we must examine capitalised expenses for validity.

Conduct risk

The conduct provision charge has increased by 36% ((45/33) - 1) since the prior year. Given the current political environment surrounding banks the risk of unrecognised conduct provisions must be addressed.

Credit risk

The net impairment charge has increased by 25% ((10/8) - 1) which is a significant increase. Given the information in Exhibit 2 this impairment charge may be understated.

Loans and advances to customers have increased by 34% ((8,230/6,120) - 1) since 2016 and control must be maintained to ensure that overall risk is consistent with Mariko's risk appetite and to ensure the balances are not overstated due to unrecognised impairments.

Impairments as a percentage of loans to customers have remained fairly stable at 0.12% (10/8,230) in 2017 compared to 0.13% (8/6,120) in 2016. This is low but as the mortgage portfolio is secured against property, the impairment percentage is not expected to be high. We do not have sufficient information to calculation impairment as a percentage of gross loans to customers, but the trend should be the same.

The increase in higher loan-to-value (LTV) mortgages and expected increases in interest rates in Exhibit 2 raises the issue of whether there may be unrecognised impairments and overstated financial assets. The loss suffered by Mariko in the event of borrowers' financial difficulties would be greater given the higher LTVs.

The presence of renegotiated loans raises the risk of unrecognised impairments if forbearance is used as a tool to avoid impairment charges in the current year.

Funding risk

There is low interbank funding evidenced by the relatively low levels of loans and advances to bank and deposits from banks. Mariko has access to funding from its Japanese parent, but if this funding were delayed or unavailable this could cause short or longer-term issues if alternative funding is not forthcoming from other banks.

Mariko has increased its reliance on deposits from customers to expand its loan book. The loan to deposit ratio has increased from 2.18 (6,120/2,800) in 2016 to 2.42 (8,230/3,400) in 2017. At times of stress wholesale funding reacts faster so there may be future liquidity issues.

The Prudential Regulation Authority (PRA) requires banks to maintain minimum liquidity levels to withstand a 30-day stress period and there is a regulatory risk that these levels are not maintained at the required level.

Funding from the parent has increased by 43% since 2016 ((2,000/1,400) - 1) indicating that deposits have not increased in line with loan book growth. There is a risk that funding does not match the tenor, currency and interest rates of lending which exposes Mariko to market risks. The parent loan is for a maturity of one year at a variable rate compared with mortgage loans and advances for longer terms and potentially at both fixed and variable rates.

There has been £500 million of debt securities issued on 1 September 2017 with a six-month maturity which could indicate funding problems.

Loan to value (LTV) analysis

Loan book by LTV category:

	2017 (draft)	**2016**
Less than or equal to 50%	6%	13%
Greater than 50% and less than or equal to 75%	22%	35%
Greater than 75% and less than or equal to 90%	34%	32%
Greater than 90%	38%	20%

There has been a deterioration in loan book quality from 2016 to 2017 with an increase in LTVs at higher percentages. This has not been reflected in the lower net interest margin calculated above. This may be because of increased competitive pressures or funding pressures.

Regulatory and compliance risk

The PRA will require a UK banking subsidiary of an overseas bank to meet the regulatory requirements applied to any other UK bank. This includes financial resources meeting the minimum levels of capital and liquidity and non-financial resources including appropriate governance including a board, a suitable risk management framework and systems that are fit for purpose.

Examiner's comment

Many candidates identified a number of relevant risks and explained them clearly using the financial information provided in Exhibit 1 and the narrative explanations in Exhibit 2.

However, many candidates misread or misunderstood the requirement that asked for analytical procedures for the purpose of identifying risks. Analysis of Mariko's performance was often undertaken without identifying any risks from the analysis.

Some candidates mistook analytical procedures to mean substantive audit procedures and provided audit procedures for every risk they identified. This did not gain marks as it was not requested in the question.

Where audit procedures relevant to impairment were mentioned here, they were awarded marks under requirement 2.2.

Total possible marks	15
Maximum full marks	13

2.2

Loan-to-value (LTV) analysis

Financial reporting treatment

Loans and advances are impaired if the present value of future cash flows, discounted at the original effective rate, is below the asset's carrying amount.

The draft figures reflect a collective impairment allowance calculated using historic default rates. As Mariko's mortgage product mix has changed in 2017, this may no longer be the most relevant way to calculate impairment allowances.

Historically, buy-to-let mortgages have had a lower LTV and therefore even if the borrower defaults there is sufficient security to recover the debt if foreclosed.

In 2017, the percentage of loans with a LTV of 91% or higher has increased by 152% ((3,130/1,240) -1) compared to 2016. These loans carry a higher probability of default. However, the exposure at default should be low given the value of the security (house prices) is rising.

Mariko should consider whether individual assessment of impairment is more relevant in 2017.

Mariko should assess first whether there are any individually significant loans. This is unlikely to be the case for retail mortgages. Mariko should then assess whether there is any objective evidence of impairment for loans and advances on an individual or collective basis. It may be appropriate to look at loans with a high LTV on an individual basis.

Remaining loans with similar credit characteristics may be assessed for impairment on a collective basis. The collective impairment allowance should not only take into account historical default rates, but should also reflect data such as employment rates, length of time past due date, property prices for security valuation, inflation and interest rates for affordability.

Further, Snook can assess whether Mariko has applied any affordability criteria for underwriting these loans. If applied, this should have constrained the value of the loan that Mariko can extend for a given income and can reduce the probability of default on the loan particularly in an environment of rising interest rates. At higher levels of indebtedness, borrowers are more likely to encounter payment difficulties in the face of shocks to income and interest rates.

Also, in addition to LTVs, the mortgage's interest coverage ratio (ICR) can be considered in assessing affordability for the borrower.

Audit procedures

The LTV analysis does not need to be audited if it does not form part of the financial statements. However, if it is included in the annual report the auditors are responsible for ensuring it is consistent with the information in the financial statements. If this is not the case, an 'Other Matter' paragraph in the audit report will be needed to highlight the inconsistency.

The LTV analysis is important to assess the requirement for impairment allowances.

Audit procedures to be performed should include:

- Identify whether any mortgages have been identified as individually significant and if so ensure that they have been removed from the portfolio before assessing the collective allowance.
- Assess whether loans have been apportioned into appropriate pools for collective assessment taking into account LTV, maturity date, employment status, geographical location etc.
- Obtain market forecasts for house price data and inflation and ensure that Mariko's collective impairment allowance reflects these forecasts.
- Compare the collective impairment allowance to historical default data to ensure this has been reflected and updated as appropriate.
- Benchmark Mariko's treatment of impairment of loans and advances using Snook's knowledge of the banking industry.
- Perform sensitivity analysis of the key inputs to the collective impairment allowance such as higher than expected unemployment or inflation.
- Discuss with Mariko how the emergence period is reflected to allow for the time delay between an event occurring which provides objective evidence of impairment and Mariko becoming aware of the event (eg through customer notification).
- Ensure that the methodology and assumptions used for estimating future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.
- For a sample of loan balances, reperform the calculation of LTV and examine the cause of any discrepancies found.
- Gain assurance over the collateral valuations by performing sample testing and considering using an independent surveyor.
- Assess whether interest income benchmarks used for customers to assess affordability are appropriate.
- Ensure that interest income is considered after all relevant charges eg estate agent fees, stamp duty land tax etc.

Renegotiated mortgages

Financial reporting treatment

There is an issue around whether forbearance terms have been offered to customers to avoid recognising impairment allowances against the loans in the north east of England. Mariko must assess at each reporting date if there is any objective evidence of impairment. If such evidence exists, the loans must be subject to an impairment review by comparing the carrying amount at amortised cost to the present value of estimated future cash flows, discounted at the original effective rate.

The calculation of the present value of the estimated future cash flows of a collaterised financial asset reflects the cash flows that may result from foreclosure and any costs for obtaining and selling the collateral, whether or not foreclosure is probable.

Audit procedures

In addition to the audit procedures above, Mariko should:

- Obtain and evaluate Mariko's forbearance policy statement to ensure it has been applied consistently.
- On a sample basis, recalculate the present value of future cash flows reflecting the forbearance terms allowed and determine whether an individual impairment allowance is required.
- If errors are found on a sample basis, ensure that all loans subject to forbearance are subject to further substantive procedures.
- On a sample basis, recalculate interest accrued on forborne loans and ensure it is included accurately in interest income in the statement of profit or loss.
- Ascertain the robustness of Mariko's assessment of other mortgages in the north east of England for evidence of impairment.
- Review the collateral valuation policy and assess whether appropriate benchmarks (indexation) have been applied when considering evidence of impairment.
- Ensure that there are additional disclosures in the financial statements for forborne loans.
- Identify the proportion of forborne loans in the last year which have subsequently gone into default to ascertain whether forbearance has been used to mask impairment.

Examiner's comment

A reasonably well answered requirement.

Marks were not awarded for the financial reporting treatment of loans and advances on initial recognition because the outstanding issues related to impairment of existing loans.

Total possible marks	19
Maximum full marks	15

2.3

Both the audit manager, Lee, and the audit firm, Snook, hold personal and corporate mortgages with Mariko respectively. According to the ICAEW Code of Ethics, this is a self-interest threat to objectivity.

There is a threat, or others could perceive, that the financial interest in Mariko will inappropriately influence either Lee's or Snook's behaviour or judgement. There could also be an intimidation threat if Mariko threatened, openly or otherwise, to close the mortgage accounts if unfavourable conclusions are reached during the audit. It is arguable whether Lee has sufficient authority to influence the outcome of the audit.

This area is covered by section 2 of the FRC's Revised Ethical Standard Financial, Business, Employment and Personal Relationships.

Lee's mortgage with Mariko is acceptable in the ordinary course of business and on normal business terms.

There is no indication that Lee's mortgage is in arrears or is treated differently to any other mortgages held. Lee's mortgage is highly unlikely to be material to Mariko. Because of this, Lee's mortgage is acceptable under ethical standards.

However, Snook's corporate mortgage with Mariko is not as straightforward. If the mortgage is material to Snook, either the mortgage should be removed from Mariko and moved to another bank, or Snook should resign as Mariko's auditor.

Safeguards should be put in place at Snook to prevent this from becoming an issue in the future. Audit staff in the banking division should be trained in this area and the staff manual should include reference to holding a personal mortgage with a client bank.

Lee could call the ICAEW helpline for advice if unsure about how to proceed.

Snook's ethics partner must be consulted regarding Snook's corporate mortgage. Sufficient time will be required to reorganise Snook's financial affairs and in the meantime the audit must be subject to a second partner review.

Examiner's comment

The ethics requirement was well answered. Candidates discussed the ethical issues facing both the audit manager Lee and Snook LLP. Reasonable actions were provided and explained sufficiently.

Total possible marks	8
Maximum full marks	5

Question 3 – Peel Bank plc

Total Marks: 25

General comments

The candidate works in the internal audit department of Peel Bank. Peel is a relatively new bank and has experienced volatile profits over the previous three years due to unhedged currency exposures.

The candidate must identify trends in profitability using three years' worth of data, outline the correct financial reporting treatment of hedge arrangements that may be set up, discuss the changes when IFRS 9 is implemented and outline controls that should be implemented over risk management.

3.1

Net interest income

Net interest income appears to have fallen in 2017 to levels below the 2015 figure. However, when analysing interest income, if currency effects are eliminated, net interest income in absolute terms has remained relatively constant between £348 million and £351 million from 2015 to 2017 (see below).

It is useful to calculate the net interest margin:

	2017 forecast £m	**2016 audited £m**	**2015 audited £m**
Net interest income (NII)	332	369	353
Currency gains/ (losses) on interest income and interest expense	(16)	18	5
NII excluding currency effects	**348**	**351**	**348**
	%	**%**	**%**
Net interest margin (NIM) (NII / average loans and advances)	3.11	3.64	3.58
NIM excluding currency effects	3.26	3.46	3.53

Net interest margin follows the same pattern as the absolute figures for net interest income. However, net interest margin excluding currency effects has been steadily falling over recent years. This may be caused by falling interest rates in the geographical areas that Peel lends to and/ or higher costs of funding.

Net fee income

Net fee income is increasing steadily year-on-year which shows that the UK private banking division is performing well. Fee expense as a percentage of fee income remains consistent around 18-19%.

The increase in net fee income has enabled total revenue to increase despite the currency effects, although revenue in 2017 is 3.6% ((566/587) - 1) below 2016 revenue. This generates volatility in Peel's revenue because revenue in 2016 is 7.3% ((587/547) - 1) higher than 2015 revenue.

Costs

The cost income ratio (CIR) for the three years is as follows:

	2017 forecast £m	**2016 audited £m**	**2015 audited £m**
Revenue	566	587	547
Currency gains/ (losses) on interest income and interest expense	(16)	18	5
Revenue excluding currency effects	582	569	542
	%	**%**	**%**
Cost income ratio (CIR)	64.3	63.9	74.8
CIR excluding currency effects	62.5	65.9	75.5

Peel has been controlling costs well and, excluding currency effects, has reduced the cost income ratio significantly each year. This explains the overall improvement in profitability year on year once currency effects are eliminated.

	2017 forecast £m	**2016 audited £m**	**2015 audited £m**
Profit	152	159	104
Currency gains/ (losses) on interest income and interest expense	(16)	18	5
Profit excluding currency effects	168	141	99

Impairments have been reducing which implies improved credit control. This has a positive impact on profitability.

Examiner's comment

This requirement generated a range of answers, but many candidates used Exhibit 1 to make sensible comments about profitability.

Total possible marks	8
Maximum full marks	8

3.2

The currency swap is a derivative which is classified and measured as fair value through profit or loss (FVTPL) under IAS 39. It is initially measured at fair value with any transaction costs taken to profit or loss and subsequently remeasured to fair value at each reporting date with gains and losses taken to profit or loss.

If hedge accounting is applied to the hedge, the currency swap is the hedging instrument. The hedged item is either the recognised financial assets (loans and advances) or the cash flows of interest and principal to be received from the financial asset.

If hedge criteria are met this would be a fair value hedge of the recognised financial assets. In this case fair value gains or losses on the hedged item and hedging instrument are taken to profit or loss. Otherwise, if designated as such, it would be a cash flow hedge of the future cash flows to be received under the contract. In this case, the effective proportion of the hedge is taken to other comprehensive income and transferred to profit or loss when the cash flows affect profit or loss.

Hedge criteria include the stipulation of effectiveness. Given the maturities extending beyond one year the effectiveness of the swap would need to be estimated and the change in the instrument versus the change in the item must be between 80% - 125%.

Other criteria must also be met including effectiveness is capable of reliable measurement and is measured at the inception of the hedge and on an ongoing basis. The hedge must be formally designated and documented.

Under IAS 39, groups of items may be eligible as hedged items only if the items share the same risk exposure to currency movements. It is unlikely that this will be the case for all euro loans and advances because they will have different maturities and therefore exposure to changing exchange rates. Smaller groups of items could be specified to give a pool of items with the same maturity and interest rate.

In addition, the change in fair value attributed to currency risk for each individual loan within the group should be approximately proportionate to the overall change in fair value attributed to the hedged currency risk of the group.

The fair value of the OTC currency swap is likely to be level 2, IFRS 13 hierarchy.

Hedge criteria could be eliminated by using the fair value option for loans and advances to eliminate an accounting mismatch.

Examiner's comment Answers varied to this requirement, but the majority of candidates explained how hedge accounting would work and tried to apply it to the situation. Comprehensive numbers were not provided in the question so that candidates could instead focus on the non-standard elements of the scenario ie hedging a group of items is possible if it shares the same risk exposure.	
Total possible marks Maximum full marks	10 6

3.3

IFRS 9 introduced a more principles-based approach to hedge accounting aligned to risk management activities of the bank. Effectiveness criteria of 80 – 125% is no longer relevant. IFRS 9 is effective for accounting periods beginning on or after 1 January 2018 so the closing balances for Peel for the year ended 31 December 2017 will be the opening balances under IFRS 9.

The IASB allows an accounting policy choice to apply either the IFRS 9 hedging model or the IAS 39 model, with an additional option to use IAS 39 for macro hedging if using IFRS 9 for general hedge accounting.

Under IAS 39, as mentioned above, groups of items may be eligible as hedged items only if the items share the same risk exposure to currency movements. IFRS 9 allows hedge accounting to be applied to groups of items and net positions if the items are managed on a group basis for risk management purposes.

A group of items subject to currency risk may be accounted for using a cash flow hedge even if the variability in cash flows is not expected to be approximately proportional to the group of item's overall variability in cash flows. Disclosures must specify the reporting periods in which forecast transactions are expected to affect profit or loss, including the nature and volume of these transactions.

Examiner's comment Well answered by the vast majority of candidates.	
Total possible marks Maximum full marks	4 4

3.4

Internal controls to monitor hedge effectiveness:

- Authorisation by risk management department required before hedging transactions are undertaken
- Written documentation proformas to be used for exchange traded products
- Risk management/ legal to agree written documentation for over-the-counter products
- Hedge effectiveness to be monitored on a daily basis
- Exception reports to be generated for hedges where effectiveness has moved away from 100%
- Actions to be decided upon for hedges <90% or >110% effective
- Exposed (unhedged) positions to be monitored on a daily basis using measures such as Value-at-risk (VaR)

Examiner's comment Generally well answered but sometimes framed as audit procedures rather than internal controls. Some candidates explained the controls more fully and gained more marks accordingly.	
Total possible marks Maximum full marks	7 7