Our response to the FRC consultation document: triennial review of UK and Ireland accounting standards

Approach to changes in IFRS

Restricted
21 December 2016

Executive summary

We welcome the proportionate and pragmatic approach proposed by the FRC towards incorporating international financial reporting standards into FRS 102. In particular, we support the decision to delay implementation of more significant changes to the standard to allow UK GAAP reporters time to benefit from the experience gained by IFRS reporters. We remain grateful to the Financial Reporting Council for allowing building societies to stay with an accounting framework that is based on a single simplified standard.

Our main concern lies with one of the more significant changes to FRS 102 – IFRS 9 Financial instruments. IFRS 9 is much more than an accounting issue. Since the FRC consultation was published, the Basel Committee for Banking Supervision and the EC have both proposed transitional arrangements to help IFRS reporters deal with the negative impact on regulatory capital arising from the introduction of expected credit loss accounting. Its impact is greater on UK GAAP building societies, which are all on the standardised approach to credit risk, than for those institutions on the internal ratings-based approach. The Basel and EC proposals mean that the full monitoring period for the capital will not be understood until end 2023 at the earliest. We therefore urge the FRC to delay further incorporation of the ECL elements of IFRS 9 until 2027. This would give stakeholders time to observe the implementation by IFRS reporters, and to develop a proportionate approach to expected loss provisioning, which may involve an alternative to the loan level PD progression approach.

Users of building society accounts

An overriding objective of the Financial Reporting Council in setting accounting standards is to enable users of accounts to receive high-quality understandable financial reporting proportionate to the size and complexity of the entity and users' information needs. We do not disagree. But we wish to highlight that the typical user of a UK GAAP building society set of accounts will not be its individual savings or borrowing members (who are its owners). Their needs are catered for by the summary financial statement which presents in an accessible way, the year's financial highlights, together with the key numbers and percentages. While entitled to a copy of the full accounts, very few members request it – the summary financial statement clearly fills the need.

Stakeholders interested in the full accounts of a UK GAAP society are mainly wholesale counterparties and the regulators, the Prudential Regulation Authority and the Financial Conduct Authority. The PRA receives regular updates on the position of building societies (and banks and other firms) through regulatory returns and direct supervisory engagement. Analysts are not interested in the accounts of smaller building societies and therefore have no need to compare them with larger societies (or banks) that use IFRS.

Question 1 *The FRC has reviewed its principles for developing succinct financial reporting standards for the UK and Republic of Ireland. As a result, limited changes have been made to the principles, to emphasise the need to balance improvement with stability and the need for proportionate solutions (see paragraph 1.11). Do you agree with the principles? If not, why not?*

The five principles outlined in paragraph 1.11 of the consultation document remain relevant for building societies and their stakeholders. The minor proposed changes add clarity so we support their inclusion. Particularly welcome are the additions of "stability" and "proportionality", two principles that are highly relevant to the building society sector. Constant changes can reduce the impact of any improvement to financial reporting so ensuring there is a balance between improvements and stability is vital. Likewise, any change has to be proportionate to the size and complexity of the firm. The "one-size-fits-all" approach risks imposing requirements that are designed for large, complex institutions onto smaller, simpler ones. Not only is this approach inappropriate and disproportionately costly, it also diverts often scarce resource away from the core business. As we argue later, wholesale adoption of IFRS 9 is a prime example of the perils of the "one-size-fits-all" approach. The underlying principles are worthy but some of the application, particularly where building societies are concerned, could lead to a change – for example, in mortgage underwriting – in the way they do business. The FRC will surely agree that financial reporting needs should not dictate how business is done.

Question 2 *Significant changes in IFRS have been considered against the FRC's principles for developing succinct financial reporting standards for the UK and Republic of Ireland; see Section 3 Changes in IFRS – Detailed analysis. Do you agree with the proposals for updating FRS 102 as result of changes in IFRS as part of this triennial review? If not, please provide alternative suggestions.*

We agree in principle. We note that one of the reasons behind the FRC's decision not to change FRS 102 to increase consistency with IFRS 3 was the findings of an IASB post-implementation review. This identified "challenges". We welcome such a pragmatic move on FRC's part and consider that consideration of the adoption of future international financial reporting standards should be made only after the findings of such reports have been reviewed.

IFRS 9

The concept of moving from an incurred loss to an expected loss framework is supported by our sector. Expected loss is a more prudent and transparent way of assessing the impairment of financial assets than the current system. But it can have a major effect on a financial institution's capital position. As we argue later, changes are needed to the expected loss model to enable it to be adopted by smaller, domestic financial institutions.

IFRS 16

IFRS 16 Leases was issued in 2016 and is effective for accounting periods beginning on or after 1 January 2019. It has a single model for lessee accounting and requires more leases to be recognised as an asset and a liability than previously. It has not yet been endorsed for use in the EU (not expected until 2017).

We agree that FRS 102 should mirror IFRS 16 and move leases on to the balance sheet. This will give a clearer picture of an institution's lease assets and liabilities. But the new right of use assets category, typically property for building societies, could present problems. The problems are not so much accounting, but regulatory – do these assets attract extra regulatory capital? Our regulator, the PRA, has referred to an IASB statement that entities can include the ROU asset where it is a lease of a tangible asset either on its own line or with tangibles. That suggests that the IASB regards it as a tangible, albeit a slightly different tangible to the normal ones.

Question 3 *In relation to the impairment of financial assets, the FRC proposes to amend FRS 102 in order to incorporate an expected loss model. Paragraph 3.13 sets out three options for how this may be achieved, with the FRC favouring option (b). Which option would you prefer, and why?*

Do you have any suggestions for how the simplified approach to impairment losses for trade receivables, contract assets and lease receivables in IFRS 9 might be developed into a suitable model for entities applying FRS 102 (other than financial institutions, or a sub-set such as banks and building societies)?

We note the FRC is minded to incorporate an expected loss model into FRS 102 for financial institutions, or for a sub-set such as banks and building societies. Our hope is that it will not be an exact copy of the model in IFRS 9. It is not just non-financial sectors that need a simplified impairment approach – building societies, and probably smaller banks, do too. While IFRS 9 was revised in response to the financial crisis, it was designed with large, international, complex banks in mind – institutions that operate completely differently to domestic building societies.

We therefore have reservations about how and when the move – itself challenging and resource-intensive - will be implemented.

The "when" reservations had been somewhat allayed by the proposal in this consultation to allow UK GAAP reporters to continue to use IAS 39 to 1 January 2022 ie after the second triennial review had taken place. Building societies welcome this step. The majority of IFRS reporters are large, international, complex institutions that have over ten years' experience of a stable accounting framework and crucially significant resources to prepare for IFRS 9. UK GAAP reporters such as building societies, on the other hand, have just completed the transition to FRS 102, or are still in the process of doing so. This has given them little time (or resource) to prepare for IFRS 9.

But things have changed since this consultation was issued. Firstly, in October 2016 - ie after the publication of this consultation on the approach to changes in IFRS - the Basel Committee on Banking

Supervision published a paper[1] on the regulatory treatment of expected credit loss provisions. Basel proposed to retain, for a transitional period of up to five years, the current regulatory treatment of provisions under the standardised and the internal ratings-based approaches for credit risk. The committee also sought comments on the possible need for a transitional arrangement to give entities time to adjust to the new ECL accounting standards. These changes are designed to give lenders more time to prepare and rebuild their capital resources following a negative impact arising from the introduction of ECL accounting and avert a "capital shock". The following month the EC made a parallel move[2]. It proposed to amend the Capital Requirements Regulation (through new Article 473a) to phase in the new incremental provisioning requirements for credit risk under IFRS over a period starting on 1 January 2019 and ending on 31 December 2023 to mitigate the financial impact on institutions.

Both moves suggest a lack of readiness and ongoing challenges with the models. In view of these moves, we think the FRC should consider setting the implementation date of IFRS 9 provisions for UK GAAP reporters to a later date, perhaps to 2027 (to include the minimum three years "bedding-in" time[3]). In chapter 1.20 of this consultation, the FRC says it wants to offer "entities more time to prepare for transition and to be able to learn from the experience of listed groups already applying the IFRS standards on which the amendments are based." Given Basel and the EU are effectively proposing a five-year glide path ending 31 December 2023, it could lead to smaller entities such as building societies feeling the impact on capital ahead of larger building societies, and without the full benefit of their experience.

Even more importantly, smaller building societies do not have the equivalent longer time to rebuild their capital resources following the introduction of ECL accounting that larger institutions now will have. This could leave them more exposed to a capital shock.

IFRS 9 has a further disproportionate effect on UK GAAP building societies as ECL provisions interact with regulatory capital. They – and some IFRS societies - follow the standardised approach to credit risk whereas the very largest societies (and banks) follow the internal ratings based approach. Under IFRS 9, a rise in impairment depletes the capital adequacy of firms such as most building societies that use the standardised approach to credit risk, as the 1:1 reduction in capital arising from increased impairments is not offset by reduced risk weighted assets.

The Bank of England, along with other commentators, has expressed concern about the issue. In its response to the European Commission Call for Evidence on the EU Regulatory Framework for Financial Services, January 2016[4], it says its analysis suggests that firms using IRB approaches will be able to have accounting provisions increase substantially before regulatory capital is affected. The Capital Requirements Regulation rules require that firms using standardised approaches, on the other hand, see capital reduced on a pound for pound basis as accounting provisions increase. This issue needs to be addressed urgently ahead of any decision on implementing IFRS 9, as the building society sector relies on retained earnings for capital generation. We understand the BoE strongly supports the Basel proposals to phase in change that could result in capital shock.

[1] See www.bis.org/bcbs/publ/d386.htm
[2] See proposal to amend regulation (EU) No 575/2013 at https://ec.europa.eu/transparency/regdoc/rep/1/2016/EN/COM-2016-850-F1-EN-MAIN.PDF
[3] See chapter 3.15 of the consultation document for rationale behind FRC proposal to delay the effective date for the expected loss model.
[4] See http://www.bankofengland.co.uk/financialstability/Documents/regframework/detailedanswers010216.pdf

Then there is the FRC's own timetable. The FREDs for phase 2 of the triennial review will be drawn up in 2017 and issued for consultation in Q3 2017. While that timescale gives the FRC adequate time to consider the responses to this consultation, it does mean the FREDs will be produced ahead of even one reporting cycle. To produce a meaningful FRED with a proportionate expected loss model, the FRC needs, in our view, to see a full set of IFRS 9 accounts and review the impact on capital. IFRS 9 is much more than an accounting issue.

Our reservations about how a move to an expected loss model is made are even more complex. A loan level probability of default progression-based approach to loan loss impairment accounting is not consistent with how UK GAAP building societies underwrite loans. Unlike larger IFRS reporters, many of which use an automated scorecard-approach, they underwrite loans manually and apply judgement to the particular circumstances of each individual customer. Loan portfolios are therefore more idiosyncratic and concentrated in terms of loan numbers. The same contrast exists in terms of capital requirements: larger IFRS building societies and banks use the internal ratings approach with loan level PD, EAD and LGD whereas UK GAAP reporters operate on the standardised approach with portfolio-level risk weights. A transition to a loan level PD progression approach would therefore be a significant departure from the credit risk management approach of UK GAAP societies. Changing the fundamental basis on which a sector operates merely to fit in with accounting imperatives, themselves designed for large, complex banks, is hard to defend.

For building societies, the expected loss accounting that is eventually adopted must be appropriate and proportionate. Due to the current business model, there is a very real lack of sufficient internal data on impairment for analysis. This will mean external data will have to be bought, which may not reflect the risk profile of the loan book, for the PD progression based approach, or a non-model based approach built on judgement will be required. One stakeholder has estimated that the cumulative cost over a five-year period of obtaining externally-sourced data for a loan level PD progression approach is equivalent to around 13.5bps of a typical small building society's mortgage assets. This is roughly the level of average collective provisions on residential loan books for UK GAAP societies. We believe there has to be a more cost-effective solution for smaller entities than that. An alternative credit loss approach could be one based on portfolio-level judgment rather than loan level PD progression A longer implementation period, particularly if the proposed FRC implementation date of 2022 is delayed until 2027 to reflect the Basel and EC transitional ECL proposals, might provide the opportunity to identify a workable approach for UK GAAP reporters.

Another benefit of an extended delay is that the results of the European Banking Authority's second impact assessment of IFRS 9 will be available. These will be of crucial importance to the financial services sector since the results set out the estimated impact of IFRS 9 on regulatory own funds, the interaction between IFRS 9 and other prudential requirements and the implementation issues relating to IFRS 9. The regulatory own funds point is particularly pertinent for our sector; we discuss earlier in this response IFRS 9's disproportionate effect on firms on the standardised approach to credit risk, which is used by all UK GAAP building societies (and some IFRS building societies too). Until this is addressed, UK GAAP building societies face a "double whammy" on capital treatment, putting them at a competitive disadvantage to large banks and larger building societies.

It comes as no surprise, therefore, that while the proposed extension of the option to choose the recognition and measurement requirements of IAS 39 is most welcome, we consider it is not long enough. In our view, the option should incorporate the transitional period proposed by Basel and the EC. This means the option should remain for accounting periods beginning before 1

January 2027. That would not stop those UK GAAP reporters who wished to adopt IFRS 9 early.

Notwithstanding the above, it is important to emphasise that the significant majority of societies adopted FRS 102 with IAS 39 due to the lack of a macro fair value hedge accounting option within FRS102. A smaller number of societies were also driven this way by having certain products which met the definition of a non-basic financial instrument. We would encourage the FRC to clarify and make amendments to the standard to allow societies to elect to make independent choices for the application of impairment and hedge accounting to ensure that the hedge accounting situation does not drive the policy choice for impairment as was the case with chapter 11/ 12 and IAS 39. For example, this would allow societies to adopt IFRS 9 for hedge accounting only and retain IAS 39 for impairment until the date for full transition to expected loss accounting or vice versa.

Question 4 *Presently, in paragraph 11.2 (and paragraph 12.2), FRS 102 permits an accounting policy choice in relation to financial instruments, allowing an entity to choose the recognition and measurement requirements of FRS 102, IAS 39 Financial Instruments: Recognition and Measurement or IFRS 9 Financial Instruments (and elements of IAS 39 as amended by IFRS 9). The FRC proposes to retain the option to choose IAS 39 until the requirements for the impairment of financial assets have been amended in FRS 102 (ie for all accounting periods beginning before 1 January 2022). From 1 January 2022 the FRC proposes that the available options will be the requirements of FRS 102 or IFRS 9. Do you agree? If not, why not?*

As we say earlier, we welcome the proposed extension of the accounting policy option to choose the recognition and measurement requirements of IAS 39. We consider it a pragmatic solution for smaller entities such as building societies which may not have the resources to adopt the impairment provisions of IFRS 9 at the same time as larger, more complex entities. But we think the extension should be longer. In our view, the option should incorporate the transitional period proposed by Basel and the EC. This means the option should remain for accounting periods beginning before 1 January 2027. That would not stop any UK GAAP reporters that wished to adopt IFRS 9 early. In the meantime, societies should be able to continue to adopt the hedge accounting and/ or impairment aspects of IAS 39.

Question 5 *Do you have any suggestions for how the requirements of IFRS 16 Leases might be developed into a suitable model for entities applying FRS 102? In particular, do you have any suggestions relating to the application of the short-term lease exemption or the exemption for leases when the value of the underlying asset is low?*

Under IFRS 16 the short term lease exemption of 12 months would seem appropriate. In respect of the low value exemption experience, the approach to definition in absolute terms does not appear to be an issue. As with IFRS 9, however, a delayed implementation to benefit from the practical experience of IFRS reporters before finalising requirements for FRS 102 would seem appropriate.

Question 6 *The FRC proposes to makes changes to FRS 102 to incorporate the control model of IFRS 10 Consolidated Financial Statements. Company law specifies when consolidated financial statements are prepared, and any changes would supplement these existing requirements by providing further guidance on what is meant by 'control'. Are you aware of any legal barriers to incorporating the control model of IFRS 10 alongside the existing legal requirements?*

In most situations, any changes to the definition of control in FRS 102 will have no impact in practice. However, in other cases entities may be consolidated for the first time or cease to be consolidated. Do you have any information about how significant the

practical impact may be and the circumstances in which it might occur?

We understand the changes to be minor, principally revising the definition of control and providing guidance on its application, and therefore have no comment.

Question 7 *Do you have any comments on the cost-effectiveness of the requirements for share-based payments, currently set out in Section 26 Share-based Payment of FRS 102? If you consider that alternative requirements would be more cost-effective, please provide details of how you would adapt the current requirements whilst still providing useful information to users.*

Valuing share-based payment transactions is not part of a building society's business so we have no comment.

Question 8 *Do you agree with the proposed effective dates for the amendments arising from the triennial review, with incremental improvements and clarifications effective from 1 January 2019 and more fundamental changes effective from 1 January 2022?*

We agree with the staggered start. Furthermore, we commend the FRC for recognising that UK GAAP reporters such as building societies benefit from later adoption of transformative international standards such as IFRS 9. As it currently standards, IFRS 9 has the capacity to change the way a society does business, for example in mortgage underwriting, as well as have a significant impact on its regulatory capital. Deferring implementation until 1 January 2022 is therefore a welcome and pragmatic move. But in light of recent Basel and EC pronouncements on transitional arrangements for expected credit loss, we consider it prudent to further defer implementation ie beyond 2022 to 2027. Otherwise, there is a risk that smaller building societies lose out on the benefit of larger societies' experience. Even more importantly, they do not have the equivalent longer time to rebuild their capital resources following the introduction of ECL accounting that larger institutions now will have. This could leave smaller building societies more exposed to a capital shock.

It goes without saying that the costs of any regulatory change are disproportionately higher for smaller entities such as the majority of building societies**.**

Question 9 *Do you have any other comments on the approach to keeping FRS 102 up-to-date as part of the triennial review?*

No comment.

Question 10 *The FRC will be preparing consultation stage impact assessments to accompany the FREDs arising from the triennial review. At this stage do you have any comments on the costs and benefits likely to arise from the outline proposals in this Consultation Document that will help inform those impact assessments? Please provide evidence to support your views of any quantifiable costs or benefits.*

The impact on the banking sector, not just building societies, of adopting expected loss accounting on regulatory capital will be significant, a fact recognised by standard setters and regulators. The transition needs to be carefully managed from the start to avert a crisis.

We have already highlighted that the resource cost to building societies of adopting expected loss accounting as currently set out in IFRS 9 will be high. Advisers will be used by most, if not all, societies at the start of the project, and most probably afterwards on an ad hoc basis. They will not be cheap. Such a new approach means audit fees will also be significantly higher, particularly on implementation. While the welcome delayed start to IFRS 9 for UK GAAP reporters does

reduce the impact of the changes, individuals with IFRS 9 experience will still be expensive and London-based (all societies are located outside the capital).

And then there is the cost of data. Building societies do not have sufficient or relevant loan impairment data as they experience relatively few defaults. This means they would have to buy in such data. One stakeholder has estimated that the cumulative cost over a five-year period of obtaining externally-sourced data for a loan level PD progression approach is equivalent to around 13.5bps of a typical small building society's mortgage assets. This is roughly the level of average collective provisions on residential loan books for UK GAAP societies.

We believe there has to be a more cost-effective solution for smaller entities than that. An alternative credit loss approach could be one based on portfolio level judgment rather than loan level PD progression A longer implementation period, particularly if the proposed FRC implementation date of 2022 is delayed until 2027 to reflect the Basel and EU transitional ECL proposals, might provide the opportunity to identify a workable and proportionate approach for UK GAAP reporters.

By Andrea Jeffries
Policy Adviser
andrea.jeffries@bsa.org.uk
020 7520 5911

York House
23 Kingsway
London WC2B 6UJ

020 7520 5900
@BSABuildingSocs
www.bsa.org.uk

BSA EU Transparency Register No: 924933110421-64

www.bsa.org.uk

The Building Societies Association (BSA) is the voice of the UK's building societies and also represents a number of credit unions.

We fulfil two key roles. We provide our members with information to help them run their businesses. We also represent their interests to audiences including the Financial Conduct Authority, Prudential Regulation Authority and other regulators, the Government and Parliament, the Bank of England, the media and other opinion formers, and the general public.

Our members have total assets of over £345 billion, and account for approximately 20% of both the UK mortgage and savings markets