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Need to know

Reporting in uncertain times: Impact of recent events in the banking sector

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Further information

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www.ukaccountingplus.co.uk
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The recent weeks have been the most challenging for the banking sector since the 2008 financial crisis: in addition to the takeover by UBS of Credit Suisse, three mid-sized US banks have failed.

These developments are occurring against a backdrop of ongoing challenges and uncertainty brought about by the current macroeconomic and geopolitical environment. For example, as a result of significant global supply chain disruptions, energy prices and labour shortages, many product and employment costs have increased. At the same time, global central banks have been raising interest rates in an attempt to temper the impact of historically high inflation rates.

As noted in Deloitte's **Accounting roundup—Closing Out 2022**, entities need to bring greater transparency to how they are dealing with this challenging landscape. This *Closing Out* publication remains a relevant source of information on key financial reporting considerations in uncertain times. In particular, the recent events may result in a tightening of the credit conditions beyond what had already been observed in the past months. As a result, entities regardless of their exposure to the failed banks, should ensure that they are disclosing, in a timely manner, information about their liquidity risk, as required by IFRS 7 *Financial Instruments: Disclosures*, and going concern and significant judgements, as required by IAS 1 *Presentation of Financial Statements*.

In this publication, we address key financial reporting matters associated with the recent events for entities that apply IFRS Accounting Standards.

Financial reporting matters not specifically associated with an exposure to a failed bank

The guidance in this section is most relevant to financial institutions; however, certain topics, such as those related to expected credit losses (ECL) and impairment of intangible assets, may also apply to non-financial entities.

Disclosure of risk management/hedging strategy/liquidity

Market commentators have observed that some recent bank failures have highlighted the speed by which depositors can withdraw their deposits, as a result, in particular, of the widespread use of digital banking by corporate and retail deposit holders. The risks for a bank are increased when liquidity is dependent on a concentration of depositors and other lenders that have the unilateral right to withdraw their funding. To help users understand an entity's liquidity risk, IFRS 7 requires specific tabular disclosures of the contractual maturity of financial liabilities, and importantly requires an

explanation of how liquidity risk is managed. Liquidity risk, market risk and interest rate risk management disclosures that tie in with the broader asset and liability risk management of the entity are particularly important in times of volatile interest rates and risk aversion. Information about significant concentrations of liquidity risk in either assets or funding sources is likely to also be relevant.

Recent events have highlighted the importance of a better understanding of the interaction of risk management and hedge accounting given that whilst hedge accounting is not required it may only be applied if it is consistent with risk management. IFRS 7 requires disclosure of risk management strategy for each category of risk exposure. Such disclosures are of greater value if the entity explains how the execution of this strategy ties in with the entity's choice of how it hedge accounts. In addition, unlike IFRS 9 *Financial Instruments*, IAS 39 *Financial Instruments: Recognition and Measurement* permits entities to voluntary de-designate hedge accounting relationships. For entities applying the hedging requirements in IAS 39, disclosure of the entity's motivations for de-designating, and how such activity ties in with its risk management strategy, is particularly important. Irrespective of whether IFRS 9 or IAS 39 is applied for hedge accounting relationships, the entity should disclose new sources of hedge ineffectiveness which emerge, if any, as required by IFRS 7.

Expected credit losses
ECL reflect a current probability weighted calculation of cash shortfalls arising on debt instruments, lease receivables, written loan commitments and financial guarantees. The estimation of ECL should consider the impact of the current economic environment on a borrower's ability to repay, specifically the impact arising from inflation, higher interest rates, lower corporate profitability and reduced household incomes. The general widening of credit spreads will lead to an increased likelihood of exposures moving from 12 months to lifetime ECL. This reflects the fact that the recent events may have given rise to a significant increase in credit risk relative to the credit risk that existed when the exposure was first recognised. This may be more concentrated for exposures to certain sectors and geographies reflecting the disproportionate burden inflation and interest rates may have on those groups compared with others.

Impairment of intangible assets
Entities may have goodwill and intangible assets, such as core deposit intangible assets, asset management and brokerage-related contracts and relationships, or credit card holder and merchant relationships recognised from a previous acquisition. IAS 36 *Impairment of Assets* requires an entity to consider (among other factors) significant change with an adverse effect in the technological, market, economic or legal environment in which the entity operates or in the market to which an asset is dedicated. In doing so, entities should consider whether recent events have adversely affected the recoverable amount of the cash generating units as a result of, for example, a decline in market capitalisation or an outflow of deposit balances. Further, entities should evaluate whether customer and third-party relationships underlying certain intangible assets have been affected by consumer behaviour and whether this could be indicative of impairment. See Deloitte's **Accounting roundup—Closing Out 2022** for additional considerations related to impairment of non-financial assets.

Financial reporting matters associated with an exposure to a failed bank
In addition, the following non-inclusive list of questions may be relevant to entities with exposure to a failed bank.

- *Does the entity have cash deposits or cash sweep accounts with a failed bank?*

  In general, in the U.S., when a bank enters receivership, uninsured depositors could receive a receivership certificate from the appointed receiver. There have been cases in which uninsured depositors of bridge banks were fully protected by the Federal Deposit Insurance Corporation (FDIC) and no receivership certificates were obtained. However, if a receivership certificate was received, the instrument would be viewed as a financing receivable rather than as cash or a cash equivalent and would be subject to ECL requirements in IFRS 9. For uninsured deposits in bridge banks that have not been fully protected, it would be inappropriate to believe that there is no risk of loss under an assumption that regulatory agencies would provide protection for uninsured deposits. Entities should also consider whether additional risks are present, for example if provisions are in place that restrict the timing of withdrawing deposits.

  In the U.S., cash sweep accounts are generally FDIC-insured up to the established limit and are treated similarly to a deposit account (whether insured or uninsured, respectively). These accounts are designed to sweep funds to money market accounts held in custody by the counterparty separately from that counterparty's assets. Securities (including money market accounts) held in custody of a bridge bank are expected to be transferable to another third-party custodian. Entities may wish to contact the bridge bank or appointed receiver to determine whether to expect any access delays to the funds as a result of business interruption.

- *Did the entity take action that potentially breached its existing debt covenants?*

  Certain debt agreements have covenants that (1) require deposit accounts to be held with a particular bank (e.g. a specified liquidity metric involving cash or securities held in a qualifying account) and (2) may have been breached by the entity's response to a bank failure (e.g. to transfer cash to another bank). Bank failure may affect the enforceability of debt covenants by the lender on the basis of contractual terms; however, the legal rights of the receiver should be considered. If a covenant is breached, its remedies may permit the lender (or receiver) to call the debt, causing it to be considered due on demand. This may require the classification of the debt a current liability applying IAS 1.

- *Did the entity, or does it plan to, modify, exchange, or otherwise alter its debt agreements or obtain alternative financing?*

  If so, applying IFRS 9, the entity must consider whether the modifications are substantial. This typically involves qualitative factors as well as an assessment of whether the modifications result in a change in the net present value of the instrument's cash flows of more than 10 per cent (the "10 per cent test"). When a modification is substantial the existing financial liability is derecognised, and the new liability is recognised at fair value resulting in a gain or loss. It is particularly important to note, however, that an adjustment to the carrying amount will result even when the modification is not substantial and so is not derecognised (determined by discounting the revised cash flows at the original effective interest rate).

- *Does the entity hold loan commitments or standby letters of credit exposed to bank failure?*

  IFRS Accounting Standards do not provide specific guidance on the measurement of a loan commitment that is outside the scope of IFRS 9 from the perspective of the holder. When the holder of the loan commitment pays the writer compensation for entering into the agreement, the fair value of the compensation should be recognised as an asset. From the holder's perspective, the asset represents the right for the entity to borrow in the future on pre-specified terms which may be favourable. Similarly, standby letters of credit held are a form of financial guarantee that are recognised at the fair value of the compensation paid.

  If the entity has a loan commitment or standby letters of credit exposed to bank failure it should consider whether the asset is impaired. The entity should also consider the potential disclosure impacts related to liquidity and going concern.

- *Will changes in credit risk, or the entity's response thereto, affect its existing derivative contracts?*

  If so, the entity should evaluate the contractual terms of such a derivative contract to determine whether an event of default has occurred and is continuing, whether the contract remains in effect, the rights of non-defaulting parties, and the impact of such contractual terms on fair value measurement.

- *Will exposure to bank failure, changes in credit risk, or the entity's response thereto, affect its existing hedging relationships?*

  Debt that is owed to a bridge bank, i.e. a temporary bank set up by regulators in response to a failed bank, may have been designated as a hedged item in a qualifying hedging relationship. If so, the entity should consider the impact on hedge accounting. For example, issuance of replacement debt may cause an entity to discontinue its hedging relationship, depending on how it identified the hedged item in its designation documentation.

  A forecasted issuance of debt (or underlying forecasted interest payments) may be designated in a qualifying cash flow hedging relationship that is interrupted by a bank failure (e.g. ongoing negotiations are halted). If so, the entity should consider, on the basis of its documented hedge relationship, the impact of such an interruption on the timing or terms of the forecasted transaction.

- *Does the entity hold investments, or have lending relationships, that have been exposed to bank failure?*

  If the entity holds an investment in debt or equity investments issued by a failed bank, the entity will need to evaluate whether and how the subsequent measurement of such investments is affected. This will depend on the classification of the investments. For investments held at amortised cost or fair value through other comprehensive income, the entity will need to consider the impact on ECL including staging of the investments. For other investments, the entity should evaluate the impact on changes in the fair value of the investment.

- *Does the entity hold non-financial assets that may be impaired?*

  Entities that have exposure, or relationships with entities that have exposure, to failed banks may need to consider whether any non-financial assets are impaired. See Deloitte's **Accounting roundup—Closing Out 2022** for additional considerations related to impairment of non-financial assets.

- *Should the entity provide incremental disclosures?*

  In addition to disclosure of liquidity risk as noted above, an entity with an exposure to a failed bank may need to pay particular attention to the following areas.

  Going concern

  If the entity's material banking relationships are with a financial institution for which events or circumstances have raised concerns about failure, this may require management to assess whether the entity may be able to continue as a going concern for at least, but not limited to, 12 months from the reporting date. If management is aware of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, the entity must disclose those uncertainties.

- The entity may conclude, after having considered all relevant information, including the feasibility and effectiveness of planned mitigation, that there are no material uncertainties that cast substantial doubt about its ability to continue as a going concern which would require disclosure under IAS 1:25. However, IAS 1:122 requires disclosure of the significant judgements which the entity has made to reach the conclusion that no disclosure of material uncertainties is required under IAS 1:25, especially when other reasonable judgements may have resulted in a different conclusion.

> In assessing whether the going concern basis is appropriate, UK companies should consider a period of at least 12 months from the date the financial statements are authorised for issue.

Events after the end of the reporting period

In general, when an event such as a bank failure occurs after the end of the reporting period, this event would be a non-adjusting event as defined in IAS 10 *Events after the Reporting Period*. Such an event is not reflected in the recognition or measurement of items in the financial statements but requires disclosure when material. Given the evolving nature of bank failures and as further details on bank resiliency unfold, entities should carefully evaluate information that becomes available after the reporting date but before the date the financial statements are authorised for issue.

Concentration of credit risk

IFRS 7:34(c) requires disclosures about concentrations of risk. Concentrations of risk arise from financial instruments that have similar characteristics and are affected similarly by changes in economic or other conditions. As explained in IFRS 7:B8, disclosure of concentrations of risk should include:

- A description of how management determines concentrations
- A description of the shared characteristic that identifies each concentration (e.g. counterparty, geographical area, currency or market)
- The amount of the risk exposure associated with all financial instruments sharing that characteristic

Further information

If you have any questions about the contents of this newsletter, please speak to your usual Deloitte contact.

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