

CP04/17 – Implications of a changing accounting framework

Summary

Firms need to consider the impact on them of the FSA's long awaited Consultation Paper 04/17 – *Implications of a changing accounting framework*. These FSA proposals are a response to the adoption of International Financial Reporting Standards (IFRS) by some firms from 1 January 2005, when IFRS become mandatory for listed companies, and to the full implementation of FRS17 by firms which follow UK GAAP. The FSA is trying to be pragmatic; it is seeking to minimise, to the extent possible, the impact of IFRS on regulatory capital and to do this is proposing only a small number of adjustments, where the effect on regulatory capital has been identified as significant. These proposals are intended to come into effect on 1 July 2005. The FSA will undertake a full review in two years' time to allow certain IFRS accounting issues to settle down (e.g. the EU version of IAS 39) and the new Minimum Funding Requirement, defined by the Pensions Act to be fully developed. By this time firms will also have more experience of how IFRS affects them in practice.

Management actions:

- Firms are not permitted to anticipate the proposed rules in this CP from 1 January 2005 and therefore will need to quantify the effect of applying the existing rules during the six month transitional period. Firms also need to think about both the technicalities of regulatory reporting together with, and possibly more importantly, their basis for measuring capital adequacy in order for senior management to meet their obligation to ensure the firm concerned has adequate capital at all times during this period. These considerations may result in firms needing to communicate adverse capital adequacy changes to the FSA or at least give rise to a dialogue with the FSA;
- Quantify the effect these proposals will have when they come into force on 1 July 2005, and communicate any potential significant adverse effects on their capital adequacy, as at that date, that the FSA would expect to be made aware of. Firms should factor these changes into their regulatory capital planning, including, where necessary, plans to rectify any shortfall; and
- Having considered the implications of the proposals on their business, firms should consider responding to the CP, particularly if they identify any shortcomings.

Introduction

The FSA issued CP 04/17 on 29 October 2004, setting out its proposed response to the introduction of International Financial Reporting Standards (IFRS) by many UK companies from 1 January 2005. The FSA is seeking to keep to a minimum the consequent changes to its regulatory capital and regulatory reporting rules. Comments are due by 31 January 2005. The new rules are due to take effect from 1 July 2005 and therefore firms will have to use existing rules until that date for monthly and quarterly reporting to the FSA as well as for capital adequacy monitoring purposes. The FSA will deal with any resulting adverse capital adequacy changes on a case by case basis.

The main proposals

The CP contains four key proposals:

- For cash-flow hedges; all fair value gains and losses arising from the fair valuation of derivatives that have been accumulated in equity will be eliminated from the measurement of regulatory capital;
- The FSA proposes to follow the US approach to available-for-sale assets (but without the 55% discount for pre-tax gains) and to leave equities at fair value (with the net gains in Tier 2 capital but net losses deducted from Tier 1 capital), but write available-for-sale debt instruments back to cost or amortised cost;
- Unrealised gains or losses arising from the fair valuation of a firm's own credit risk should be eliminated from regulatory capital – whether or not this is an issue in practice depends on the final form of the EU version of IAS 39 and the ASB's implementation of it in the UK; and
- In accounting for defined benefit pension schemes the FSA proposes to give firms the option of eliminating the accounting measure of actuarial losses for regulatory purposes and replacing them by the entity's best estimate of the level of additional cash contributions that it will need to provide for its pension scheme over the next five years as determined in conjunction with the scheme's actuaries and/or trustees. Any actuarial gains arising will be reversed. This approach will apply to firms using FRS 17 as well as the equivalent IAS 19.

The above proposals are designed to remove some of the volatility introduced by the use of fair values and to recognise that the current prudential framework has been designed with UK GAAP in mind. The changes are short-term responses which will be revisited in two years' time in the light of continuing developments in IFRS and the convergence of UK GAAP with IFRS.

The other changes identified by the CP which are aimed at maintaining the status quo for firms' regulatory capital are as follows:

- The FSA wishes to maintain the principles of its existing securitisation rules and will thus continue to apply the principles of FRS 5 in assessing the securitisations of firms that have adopted IFRS - ie if the conditions for linked presentation under FRS 5 are met the existing regulatory capital treatment will continue unchanged;
- Impairment provisions against loans which arise under IAS 39 as a result of collective assessments (as in IAS 39 AG 84-92) are to be treated in the same way as general bad debt provisions under existing UK GAAP and added back to Tier 2 capital, subject to the usual cap. However, there will be no further adjustments to such provisions, even though it is expected that many banks and building societies will be required to release some of those that they currently hold as a result of the tougher tests under IFRS for establishing provisions.
- The components of regulatory capital will not be affected by any reclassifications between debt and equity as a result of implementing IAS 32; and
- The FSA sets out its own rules for netting so regulatory reporting will not be affected by the stricter criteria in IAS 32.

The FSA will accept and not adjust for the consequences of the following effects of implementing IFRS (and where indicated as a result of changes to UK GAAP):

- Only dividends paid and liable to be paid will be recognised in the P&L (dividends become liable to be paid when approved by the shareholders). Under current UK GAAP proposed dividends are accrued for as an appropriation of profit and thereby serve to reduce regulatory capital. This will lead to a one off boost to regulatory capital but the FSA will rely on the requirement that firms should not pay dividends that would leave a subsequent capital shortfall. This will apply to firms applying UK GAAP as well as those adopting IFRS;
- Share-based payments (under IFRS 2/FRS 20) will remain expensed for regulatory purposes;
- Lease classifications will follow the rules of IAS 17 without adjustment for regulatory capital;
- Goodwill and intangible assets will continue to be deducted in full from Tier 1 capital despite the change of definition under IFRS (so computer software capitalised as intangible fixed assets will be a deduction from capital); and
- Deferred tax assets and liabilities will follow IFRS.

Defined benefit pension schemes

The FSA has had difficulty formulating policy concerning the regulatory capital consequences of FRS17 and to date has not published a formal policy on this issue. Those firms who, under FRS 17 transitional arrangements have merely disclosed the effect of adopting FRS17 have not been required to make any adjustment for regulatory capital purposes. Those who have voluntarily adopted FRS17 in full, recognising the net pension fund surplus or deficit in their balance sheet, have generally not been penalised for pension deficits in their regulatory capital calculations. However from 1 January 2005 all firms following UK GAAP are obliged to apply FRS17 in full. For those adopting IFRS, the impact of the corresponding standard, IAS19, is similar. The FSA's proposals seek to reduce the impact on regulatory capital by requiring firms to put aside, by way of a deduction from capital only a proportion of that deficit – the additional contributions that firms expect to make over the next five years (as determined in conjunction with the scheme's actuaries and/or trustees) to reduce or eliminate the deficit. Some firms, particularly those with relatively small deficits, may find it simpler to deduct the deficit in full rather than to calculate the additional contribution level over the next five years and the proposals permit this. All surpluses must be reversed.

In the transitional period, six months from 1 January 2005, firms are not permitted to adopt these proposals early. The CP implies (rather unexpectedly given that there has been no prior public communication of this) that the FSA expects firms to deduct any pension deficit from regulatory capital in full (and presumably take credit for any surplus). This could significantly affect the level of a firm's capital adequacy unless firms affected have already agreed with the FSA that the deficit can be set aside. The CP goes on to suggest that this will trigger a need to inform the FSA under its Supervision Manual Chapter 15 Notifications to FSA requirements which the FSA will deal with on a case by case basis.

'Informally however, the FSA have indicated that they regard early adoption of their proposals as best practice. Nonetheless firms may well find it appropriate to confirm their approach with their FSA supervisor.'

Transitional arrangements

Under CP 04/13 – the July 2004 quarterly consultation – the FSA intends that firms adopting IFRS for financial reporting purposes (on either individual accounts or group accounts) use IFRS when preparing prudential returns. Many firms adopting IFRS from 1 January 2005 may well have some, but possibly not all, of the IFRS reporting systems and IFRS adjustments in place from day 1. Seemingly, the FSA's proposals do not enable an IFRS adopter to continue to monitor capital adequacy and prepare regulatory returns under UK GAAP for an initial period post 1 January 2005 to help firms bridge this difficulty (assuming it is practical for a firm to reverse any IFRS adjustments or the effect of any newly implemented IFRS accounting systems). Some firms could find themselves neither being able to adopt IFRS in full nor being able to reverse its IFRS adjustments completely to return to the accounting records to UK GAAP. It is not clear whether the FSA will accept, as a pragmatic expedient, a mixed basis for measuring, monitoring and reporting capital adequacy. To enable senior management to discharge their responsibilities, firms would be well advised to ensure they have agreed with the FSA the basis on which they are expected monitor and report capital adequacy in this transitional period.

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