

Box 11

FINANCIAL STABILITY IMPLICATIONS OF THE NEW INTERNATIONAL FINANCIAL REPORTING STANDARDS

The International Financial Reporting Standards (IFRS) are the accounting rules issued by the International Accounting Standards Board (IASB). The policy discussion surrounding the IFRS has centred around the potential impacts on financial stability that could be both temporary and more permanent. This discussion has been particularly prominent in the EU given the adoption of Regulation (EC) No 1606/2002, which requires all listed European companies, including banks, to publish their consolidated financial statements in accordance with the IFRS from 1 January 2005 onwards. However, to ensure appropriate oversight, these standards need to be formally endorsed before they become legally binding in Europe. The EU endorsement process for accounting standards involves three stages:

Stage I: Proposal by the European Commission

The Commission identifies the specific accounting standard and submits it to the Accounting Regulatory Committee (ARC) with a proposal to either adopt or reject it. This proposal is accompanied by an analysis of the extent to which the standard conforms with the existing accounting directives as well as its suitability as a basis for financial reporting in Europe.

Stage II: Opinion of the ARC

The ARC is a regulatory Committee chaired by the Commission and composed of representatives of Member States. It has two months to deliver its opinion on the proposal to the Commission. The ARC is purely an advisory group and receives technical advice from European Financial Reporting Advisory Group (EFRAG).

EFRAG is a private sector forum composed by the main parties interested in financial reporting in Europe, namely the users, those preparing standards, and the accountancy profession, which will advise on the technical assessment of the IASB standards and will provide an interpretation regarding their application in Europe.

Stage III: The Commission decides whether or not to adopt the standard

If the ARC supports the proposal to adopt a standard, the Commission will take the necessary measures to ensure that the standard is adopted for use within the EU's legal environment. If the ARC does not have an opinion or delivers a negative opinion, the Commission might return the issue to EFRAG or bring the matter before the European Council.

Perhaps the most significant impact of IFRS will be the fair value valuation of assets and liabilities that have not been traded, such as derivatives. Notwithstanding uncertainty over measurements of fair value when no ready market for certain assets or liabilities exist, issues with a stability dimension largely relate to the potential for higher income volatility, most notably:

- Derivatives will be measured at fair value and included on the balance sheet.
- All dealing and most investment securities held by banks will be measured at fair value.
- Banks are expected to consolidate a great number of special purpose vehicles. All business combinations will be accounted for as acquisitions. Goodwill amortisation will cease, and annual impairment tests will be introduced instead.
- Numbers traditionally regarded as exceptional, such as restructuring costs and gains and losses on trading assets, will increasingly be regarded as part of operating performance.

As is the case for many of these items, the likely impact on the volatility of reported income will at the same time also increase the understanding of investors and analysts concerning the true extent of banks' exposure to risk.

The new standards may also change banks' behaviour, and especially their risk management practices. The new reporting standards could cause concern over risk-taking if the impact on the accounts becomes less clear. In this respect, the uncertainty created by the transition may also have consequences for financial stability, most notably:

- Reserves for credit losses will be affected by the introduction of a new provisioning methodology. At the same time, the fund for general banking reserves will be reclassified as equity.
- Banks will need to review their hedging strategies and make changes to their systems and hedging documentation.
- The recognition of unrecognised actuarial losses on pension obligations may result in a decrease in equity and the reclassification of certain capital instruments from equity to liabilities.
- The overall level of provisioning allowed under the new regulatory regime will in general be smaller, as the IFRS no longer allow provisions for general banking risk.

To understand the implications of these changes better, many countries are presently undertaking impact studies. In parallel, some banks have already begun to communicate to investors what they see as the likely impact of the changes in accounting standards.