

Basel III VS Accounting Standards in the Liquidity Reporting

Nadia Cipullo^{1,*}, Rosa Vinciguerra²

¹Link Campus University – Rome, Italy

²University of Naples II – Capua, Italy

*Corresponding Author: n.cipullo@unilink.it

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Abstract Recent crisis has shown the failure of capital markets in satisfying the liquidity needs of agents. As a consequence, the Basel Committee on Banking Supervision is now paying attention to the matter of Liquidity Risk introducing provisions banks must comply with, in order to promote short-term and long-term resilience. At the same time, the IASB amended IAS 39 by introducing IFRS 9, which regulates the accounting treatment of financial instruments. Nevertheless the intent of the BCBS to discipline the Liquidity Risk and the effort of the IASB to introduce provisions designated to give relevant and useful information on the entity's future cash flows, there are some critical points associated with those requirements and coming from the combined observations of both disciplines. The problems that will highlight derive from the different objectives of the regulatory and the accounting frameworks. The first one is to serve the safety and soundness of banks and the other is to serve the public interest in terms of transparency. For this reason the IASB should think about the chance to issue a standard specific for the banking sector. Indeed, the management of financial instruments while represents the core business in the latter, has just a secondary role in non-financial entities, so it is desirable to have a differential treatment. Moreover, as the dual reporting deriving forms the differences in both disciplines may generate political costs, it could be useful to recompose the different perspectives providing a supplementary disclosure to justify the two special purposes.

Keywords Liquidity Risk, Reporting, IASB, Value, Business Model, Bank, Basel

1. Introduction

Market participants used to neglect the Liquidity Risk: they were sure that intermediaries could easily handle liquidity needs recurring to well-developed capital markets. This widespread idea did not support Regulators to provide a common framework for Liquidity Risk; it was not even taken

into consideration in the Basel II Framework. Nor surprisingly, the Liquidity Risk is often labelled as the "Forgotten Risk".

Recent crisis has shown the deficiencies of that approach and effects the Liquidity Risk can produce on the stability of banks and of the system. Recent market tensions have progressively revealed the need to manage, unlike in the past, the Liquidity Risk by establishing innovative operational approaches shared at the supranational level.

Liquidity management is becoming essential for preserving the trustworthiness of individual institutions and the stability of the entire financial system. The evolution of the banking business (from an Originate to Hold model – OTH, to an Originate To Distribute model - OTD) influenced the nature of the exposure to Liquidity Risk, which is becoming more complex and which is not matched by an adequate evolution of the banks' organization structure and of their management tools.

Because of the crisis, the Liquidity Risk turned from an "elementary operational feature", confined within the Treasury Function, to a sophisticated cross and shared characteristic, to be managed within the whole organizational structure [1].

In this new scenario, an effective and efficient management of Liquidity results in a significant competitive advantage for each intermediary.

Indeed, the Liquidity issue affects both:

- 1) the management perspective, related to the information the bank itself needs in order to appreciate, deal with, monitor its liquidity profile;
- 2) the financial reporting perspective, associated to data used by investors (whose goal is to understand the liquidity profile of the bank to make their own judgments) and Regulators (interested in monitoring the stability of the financial system).

In both cases, the provisions coming from International Authorities shape the information produced by banks. This is the reason why the attention of this research is focused, especially, on Liquidity Risk as regulated by Basel III and on IASB standards. Regarding the latter point, as there is not any specific discipline concerning Liquidity Risk in

IAS/IFRS (apart from some requirements concerning the disclosure of this risk, contained in IFRS 7), the interest of the study is narrowed on IFRS 9 – Financial Instruments. Indeed, nevertheless the awareness that the bank liquidity is influenced even by non-core activities, the main impact depends on its core business, made especially by financial instruments.

Moreover, as the regulation of the Liquidity Risk issue is an ongoing process, instead of studying IAS 39, the attention of the research has been focused on IFRS 9 ⁽¹⁾ and Basel III, which will come into force in next year.

2. Liquidity and Liquidity Risk

Liquidity is not an easy notion to define and does not have a univocal meaning: both a stock dimension, interpreted as the availability of cash or equivalents, as well as a dynamic one can be referred to. According to the latter “Liquidity represents the capacity to fulfil all payment obligations as and when they fall due – to their full extent and in the currency required. Since it is done in cash, liquidity relates to flows of cash only [9]”. Or, in a broader way, the concept may also embrace the company growth process, that is the ability to fund new business transactions; in this case “Liquidity can be viewed as the essential resource that permits a company to replace its liabilities, meet contractual obligations, and fund growth, all at reasonable price, as and where needed [2]”.

As a complex item [25], Liquidity can be investigated through its components (Banks, 2014):

- 1) Funding Liquidity: liabilities (both short and long term) from which cash can be drawn;
- 2) Asset Liquidity: availability of assets which can be sold or pledged in order to obtain cash;
- 3) Liquidity Contingencies: future events that can impact on cash flows.

In theory, if a firm owns assets and liabilities well matched (in terms of duration) and if it can hold them until their maturity, assuming the absence of new transactions, it faces no Liquidity Risk: at these conditions, maturing assets will provide the funds needed to repay liabilities as they come due. Such a model, however, is just an ideal and static (it is true only neglecting Liquidity Contingencies and impacts of future scenarios) one. Entities, especially financial institutions that operate the maturity transformation, cannot satisfy the above-mentioned conditions; moreover, they serve the accounting estimates and must deal with unexpected events.

As a consequence, Liquidity Risk is an exposure that every firm must consider and manage.

To this end, it is useful to clarify that Liquidity Risk consists of many components [2]:

- 1) Asset Liquidity Risk: coming from the inability to convert assets into cash at the expected value;
- 2) Funding Liquidity Risk: arising from an inability to access unsecured funding sources at an economically reasonable cost in order to meet obligations;
- 3) Liquidity Mismatches Risk: arises when maturities of assets and liabilities do not match, leading to divergent cash inflows and outflows over time and consequential losses;
- 4) Liquidity Contingencies Risk: refers to losses resulting from unexpected future events that may absorb Liquidity flows.

Some of them are influenced by accounting rules, in terms of recognition, measurement and disclosure.

In particular, the Asset Liquidity Risk is the most influenced by accounting rules: values assigned to assets should be predictive of their potential cash flows, while disclosure should provide useful information to investigate their timing.

Connections between the Funding Liquidity Risk and accounting rules depend on how the former is interpreted. If it is considered as previously defined (inability to access unsecured funding sources at economically reasonable costs in order to meet obligations), accounting rules do not exert a direct influence on it. On the other hand, if it is understood as the possibility that the entity will become unable to settle obligations with immediacy, amounts (measurement rules) attributed to liabilities become important, as well as their timing (disclosure rules).

Regarding the Liquidity Mismatches Risk, as financial instruments could be managed on a portfolio view, it is desirable that accounting rules take into account the specific business model adopted.

Finally, financial reporting should provide evidence of Liquidity Contingencies Risk, if not through recognition, when there are no conditions for admittance of future/potential events in financial statements, at least by adequate disclosure.

Hence, the next section will be devoted to investigate to what extent the IASB accounting rules on measurement capture these connections.

3. Basel III VS IFRS 9

For reasons mentioned above, International Authorities are now paying new attention to the matter of Liquidity Risk in banks, introducing provisions of harmonized standards. On this point, it is useful to know that since 1996, according to the Basel “*Amendment to the capital accord to incorporate market risks*”, the banks balance sheet is divided into two broad categories: the banking-book and the trading-book. While the former *comprises all assets apart from those for which the bank expresses a trading intent*, the latter *is embodied by assets and liabilities for which a trading intention exists* [26].

The reference to the distinction between trading and

¹ It should be underlined that the IASB wishes to replace IAS 39. The main steps of this project are:

Phase 1: Classification and measurement (under discussion);
Phase 2: Impairment methodology (ongoing);
Phase 3: Hedge accounting (ongoing).

banking book is important both for regulatory purposes (BCBS detects such a difference especially for reasons of capital requirements) and for accounting interventions (the classification and the measurement of financial instruments depend on, also, the different strategy, trading or booking, chosen by the management. And the measurement, giving evidence about future cash flows connected to financial instrument, affects the information relevant to the liquidity management).

Focusing on regulatory, Basel III provisions will oblige banks to manage the profile of their investments observing two rules, that have been developed to achieve two separate but complementary objectives:

- 1) the first one is to promote short-term resilience of a bank's Liquidity Risk profile through the Liquidity Coverage Ratio (LCR).

The LCR by means of a buffer (that should cover part of the difference between a bank's financial inflows and outflows in times of stress), is intended to ensure that banks hold liquid assets of high quality (HQLA) in order to withstand stressful situations for a time horizon of thirty days. Assets are considered to be HQLA if they can be easily and immediately converted into cash at little or no loss of value⁽²⁾. According to the Basel III requirements, HQLA should be at least equal to the total net liquidity outflows over a 30-day time period;

- 2) the second one is to promote resilience over a longer time horizon, by creating additional incentives for banks to fund their activities with more stable sources. To this end, banks have to comply with the Net Stable Funding Ratio (NSFR).

The NSFR aims to achieve, for the medium-term (over one year), a structural balance of bank's financial statements and to promote the use of stable sources of funding. The objective is to limit over-reliance on short-term wholesale funding during times of buoyant market liquidity and encourage better assessment of Liquidity Risk across all on- and off-balance sheet items. In addition, the NSFR approach offsets incentives for institutions to fund their stock of liquid assets with short-term funds that mature just outside the 30-day horizon for that standard. According to Basel III requirements, the NSFR is defined as the available amount of stable funding⁽³⁾ to the required stable funding. This ratio must be greater than 100%.

The new framework will probably modify the income patterns of banks as money is a scarce and expensive resource, but it will facilitate the stabilization of the whole banking system by means of an adequate management and reporting of the assumed risks.

Nevertheless, it is possible to highlight some critical points of the new discipline:

- 1) there is no consideration of profitability and growth aspects connected to the Liquidity, which is a multidimensional concept;
- 2) there is no consideration of liquidity equilibrium during the intermediate period, from one month to one year;
- 3) regarding the LCR, the denominator could be manipulated by banks according to their objective to increase/decrease the contractual cash outflows/inflows during next 30 days, modifying their funding and investment decisions;
- 4) rules concerning the frequency of disclosure to Regulators and the connected costs of non-compliance should be carefully detailed in order to avoid possible accounting policies such as window dressing.

More than provisions introduced by Basel III, banks must also comply with those coming from the IASB; in particular, we are referring to requirements diffused through the IFRS 9 – Financial Instruments.

According to the latter, the purpose of the standard is to give “relevant and useful information to users of financial statements for their assessment of the amounts, timing and uncertainty of the entity's future cash flows”. To this end the standard introduces different rules of classification and measurement for financial assets (FA) (depending on the entity's business model for managing the FA and on the contractual cash flow characteristics of the FA) and for financial liabilities (FL).

When an entity first recognises a FA, it can measure it at amortised cost (AC) if:

- 1) the FA is held within a business model whose objective is to hold the FA to collect the contractual cash flows (rather than to sell the instrument prior to its contractual maturity to realize its fair value changes) and
- 2) if its contractual terms give rise, on specified dates, to cash flows that are solely payments of principal and interest on the principal outstanding.

Even if the FA meets last two requirements, the entity can measure it at fair value⁽⁴⁾ through profit and loss (FVTPL) if doing so eliminates or significantly reduces a measurement or recognition inconsistency (fair value option).

All other FA must be measured at FVTPL.

Moreover, the IASB is judging to introduce a third category of FA to be measured at fair value through other comprehensive income (FVTOCI) for instruments that are held both in order to collect contractual cash flows and for sale and whose contractual terms give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

Concerning the FL, those held for trading are to be measured at FVTPL; others at AC, unless the fair value option is applied.

² For the purpose of calculating the LCR, assets in the stock of HQLA should be measured at an amount no greater than their *current market value* (for some less liquid assets, a haircut is applied).

³ For the purpose of calculating the NSFR, liabilities and equity should be measured at their *carrying value*, then the amount assigned to each category is to be multiplied by an ASF (*Available Stable Funding*) factor and the total ASF is the sum of the weighted amounts.

⁴ Fair Value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. IASB - International Accounting Standards Board, IFRS 13 Fair Value Measurement, May 2011.

Nevertheless the effort of the International Board to introduce provisions designated to give relevant and useful information of the entity's future cash flows, there are some critical points associated with those requirements both from a general and from a banking point of view.

First of all, is missing an explicit reference to Liquidity and to Liquidity Risk concepts; even the definition of interest in IFRS 9 (which is described as consideration for the time value of money and for the credit risk associated with the principal amount outstanding during a particular period of time) does not include the liquidity risk' component in the risk premium. As a consequence, it is important to understand how useful could be the information, provided in line with requirements of IFRS 9, to acquire consciousness of the liquidity profile of a company, especially a bank. This facet is important especially if an evaluation criterion is considered more appropriate than another for the purpose of assessing the liquidity profile of a company; it's also important to say that the fair value approach can have some influences on the pro-cyclicality.

Moreover, a weak point of the discipline lies in the lack of clarity concerning the classification - and therefore the measurement - of FA, leaving space for possible accounting policies.

On the other hand, another goal of this research is to compare rules concerning Liquidity Risk issued by the Basel Committee with the principles issued by the IASB in relation to the recognition and valuation of financial assets and liabilities, in order to highlight possible joint points as well as critical implications. In fact, there could be competing needs for financial reporting information between:

- 1) investors, who require unbiased and relevant information, according to the business model of banks, and
- 2) prudential regulators, whose aversion to the volatility of earnings and bank net assets could influence their financial reporting requirements and whose main objective is the stability of the whole financial system.

In such a scenario, new liquidity-related ratios are likely to influence accounting choices of banks. The computation of liquidity ratios requires additional reporting on items, which are already recognized and measured in financial statements (according to IFRS' provisions) [11].

For example, in the case of the *LCR* the proposed CRR (Capital Requirements Regulation) [19] establishes that the value of a liquid asset to be reported shall be its market value. While, according to IFRS 9, as mentioned before, two valuation criteria are allowed after the initial recognition, namely AC and FV; however, to some extent, judgement could be exercised in deciding which valuation option is going to be used, for example to reduce an accounting mismatch. The critical aspect is related to differences between market and fair value. Indeed, market value could diverge from fair value because of asset liquidation costs. The latter could derive from the liquidation time horizon, the asset type (standardized or not) other than its fungibility and the market structure [8]. Moreover, the fair value often is

not a market value and can be determined using valuation techniques, implying various judgments by the accountant. This could give rise to a "dual reporting", as for the same asset banks could use different valuation bases according to the diverse purpose [11].

For *NSFR*, the CRR makes no specific reference to the valuation criteria of items considered for the computation of such ratio ⁽⁵⁾. So, even in this case there could be a certain degree of accounting flexibility in deciding which is the best way to value financial instruments, trying to minimise the value of assets and increasing the value of liabilities.

The previous scenario could give rise to a window dressing, one for the calculation of liquidity ratios and the other for drafting annual accounts, inducing some stakeholders to conclude that the accounting information provided by the bank is not fully reliable. Banks perceived as less reliable could face higher political costs and an increased cost of capital, compromising their profitability [11].

All these aspects highlight the lack of orderliness in the accounting perspective of Liquidity Risk. In this context, a crucial role will be played by disclosure in notes to financial statements, which will be devoted to the illustration of the risk faced by the bank and different methods, if so, used to value financial assets and liabilities in liquidity reporting.

4. Conclusions

The objective of this study has been to evaluate if the financial reporting correctly reflects the risk exposure of banks. Indeed, nevertheless Liquidity is an important issue to be dealt with, it has been just recently addressed by the IASB and by the Basel Committee.

Problems above highlighted derive from different objectives of the regulatory framework and the accounting one. The first one is to serve the safety and soundness of banks and the other is to serve the public interest in terms of transparency and picturing economic transactions. For this reason:

- 1) the IASB should think about the chance to issue a standard specific for the banking sector: indeed the management of financial instruments while represents the core business in the banking sector, has just a secondary role in non financial entities, so it is desirable to have a differential treatment;
- 2) as the dual reporting may generate political costs, it could be useful to recompose different perspectives providing a supplementary disclosure to justify the two special purposes.

As the process of implementation of the rules concerning the Liquidity Risk in banks will be developed in a very long period, this study represents an excellent preliminary for future empirical research, to be conducted starting from next years. Indeed, information about the behaviour of a sample of banking groups will be collected, in order to test their

⁵See footnote number 3.

accounting choices for liquidity reporting in a spatial and temporal context.

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