Building Societies Association

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The future of financial reporting in the UK and Republic of Ireland
Revised financial reporting exposure drafts

Introduction

The Building Societies Association (BSA) represents mutual lenders and deposit takers in the UK including all 47 UK building societies. Mutual lenders and deposit takers have total assets of over £375 billion and, together with their subsidiaries, hold residential mortgages of over £235 billion, 19% of the total outstanding in the UK. They hold more than £250 billion of retail deposits, accounting for 22% of all such deposits in the UK. Mutual deposit takers account for 34% of cash ISA balances. They employ approximately 50,000 full and part-time staff and operate through approximately 2,000 branches.

Executive summary

Overall, we believe the revised exposure drafts go some way to building an acceptable replacement for UK GAAP. The removal of the three-tier framework and with it, the use of public accountability to determine the application of EU-adopted IFRS, are especially welcome. But we feel that FREDs 46 to 48 need changing on estimated credit losses, expected interest rate and financial instruments to make the any accounting output meaningful and effective.

We should like to record our thanks to the Accounting Standards Board and its staff for their continued willingness to listen to the concerns of our sector and suggest helpful ways forward.

Question 1: The ASB is setting out the proposals in this revised FRED following a prolonged period of consultation. The ASB considers that the proposals in FREDs 46 to FRED 48 achieve its project objective:

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.

Do you agree?

Answer 1: The response to this question depends partly on the definition of "user". The user of a typical building society set of accounts, particularly a smaller one currently using UK GAAP at present, will **not** be its members (owners), its ordinary savings and borrowing members. 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 include other (wholesale) lenders such as other building societies and banks, and the regulator, the Financial Services Authority. The FSA 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. Should a new common equity tier 1 capital instrument become available for building societies under the CRD IV, the range of users of full accounts of some smaller societies may grow.

We note the alternative view believes the ASB's objective has been subverted by a subordination of users' information needs to "high-quality, understandable financial reporting". This resonates with our some of our members as they consider aspects of IFRS - that form the basis of the FREDS 46 to 48 - unsuitable to their businesses and a trigger to accounting volatility.

In general, we agree that the proposals in FREDS 46 to 48 achieve their project objective. But not fully in respect to financial mutuals such as building societies. As we argue later, we believe the current provisions relating to estimated credit losses, EIR and financial instruments are not suitable or proportionate for the business models of financial mutuals such as building societies.

Estimates of credit losses

The majority of UK financial mutuals are on the standardised approach under Basel II This means they do not have formal predictive models with regard to loss assumptions in the same way as those mainly larger institutions on the internal ratings approach may have *although we understand that certain such large institutions have told the ASB that they do not have all the data to build these models*. Estimates of credit losses will have little objective evidence to support representing a challenge for the relationship between societies and external auditors. Potential adverse outcomes from this are:

- insufficient recognition of future credit losses as a result of a lack of objective evidence to convince external audit; or
- potential inconsistency in value of recognised future credit losses due to lack of objective evidence and auditors' inability to challenge in the absence of formal models, a position no different to general loss provisions at the moment.

We believe a more acceptable alternative is to build on existing domestic practice and devise a more qualitative solution that could be used across the sector. Suitable credit risk disclosures, including basic indicators on arrears, could then be drawn from these estimates. **We will submit further points on this issue in early May.**

Effective interest rate (general)

We have no issue in theory with income net of costs directly attributable to business generation being recognised in the interest line. We do, however, have a problem with the implementation of the effective life issue and early repayment charges.

On effective life, we have a view that income net of costs is closely aligned to the specific product term, generally 2 to 5 years (for example, a 2 year discount or 5 year fix). On smaller pools of business, where individual cases deviating from the norm have a much greater impact due to the size of pools, we think it would be better to recognise the income over the product term or, for a lifetime deal, a consistent period. This removes the administrative expense and complexity involved in monitoring multiple pools of business, and the risk of error or misstatement in the same.

While the answer is likely to be much the same, moving to an estimated life basis is much more expensive, complex to administer, prone to error and unnecessarily open to material volatility in outcome given small loan pool sizes. A simple amortisation of cost net of income over product term would be much more proportionate to administer and simpler to audit. **We will submit further points on this issue in early May.**

Effective interest rate (early repayment charges)

We are concerned about both over and underestimation of interest as a result of changes in the economic environment. Those societies for which this income is not material will still have to retain records of income across individual loan pools to prove that - a relatively expensive route to the same answer.

Where the income is more material, it is either:

1. In terms of discount mortgages, the penalty represents recovery of a discount given for not maintaining the loan for the agreed product period and the funds will be re-lent. The choice on recognition is a simple one ie recognise as received or estimate life of the income. “Lumpy” income as received is no better than an uncertain estimate.

2. In terms of non-administered rate lending, such as fixed rate swapped to LIBOR, the issue surrounds the matching of costs between the derivative and the mortgage. If the derivative has some period to go and the funds are re-lent to match against the derivative, there is an argument this is a similar position to early repayment of a discount mortgage and the same argument applies as above.

Where the derivative term is too short to re-lend if it is under 12 months, the income will likely match any derivative expense. Where there is a fundamental mismatch, however, recognition over the remaining derivative term could be adopted by the board as appropriate. This is important for fixed rate lending, perhaps more so than with other forms of lending. This is because the ERC income is more volatile, dependent on the variation of interest well above or below the pay rate, and where the rate has fallen well below the current pay rate, the availability of alternative financing at a more advantageous rate relative to the ERC payable.

Financial instruments

We understand that under IFRS 9, the effectiveness requirements have been re-assessed more on the grounds of a consistent policy set by the board as opposed to the strict 80/120 effectiveness test.

For smaller building societies, this allows a better representation of the economic reality that financial instruments are taken to hedge risk only under s9A of the Building Societies Act 1986. Therefore if they can be classed as effective, their MTM, in isolation of credit premium issues, should move broadly in line with the asset/liability hedged and net out. For smaller societies, this should reduce ineffectiveness markedly or potentially eliminate it. Provided there is a disclosure of the MTM position of these instruments with a statement that there are corresponding assets and liabilities to match, users of the accounts are fully informed. In addition, ICB reforms may bring other financial institutions within the ringfence closer to the position of societies.

In conclusion, these four points show that large, complex financial institutions should be able to access the required data far more easily and cheaply than simple, straightforward institutions such as smaller building societies. The information they produce is probably more informative than that produced by smaller institutions.

The imposition of a recognition framework designed for large and complex entities will result in disproportionate costs and unnecessarily volatile numbers, which both have negative implications for the future of institutions affected and do not provide a materially better true and fair view of the financial position of the institutions concerned under the alternatives proposed. Accordingly, standards should be amended to reflect this, or the execution of them managed in a manner which addresses these points through a SORP-like vehicle. We note the alternative view’s concern in paragraph 4.4 that MTM models fail to provide useful additional information in accounts, are hard to record and generate clutter.

Question 2: The ASB has decided to seek views on whether:

As proposed in FRED 47

A qualifying entity that is a financial institution should not be exempt from any of the disclosure requirements in either IFRS 7 or IFRS 13; or

Alternatively

A qualifying entity that is a financial institution should be exempt in its individual accounts from all of IFRS 7 except for paragraphs 6, 7, 9(b), 16, 27A, 31, 33, 36, 37, 38, 39, 40 and 41 and from paragraphs 92-99 of IFRS 13 (all disclosure requirements except the disclosure objectives).

Which alternative do you prefer and why?

Answer 2 – The ASB is proposing *inter alia* that a financial institution may take advantage in its individual accounts of the disclosure exemptions set out in FRED 47 other than those for IFRS 7 and IFRS 13.

We agree that there should be greater disclosure of the risks associated with financial instruments for financial institutions. But it is important to be clear about the operation of mutuals such as building societies. They are, of course, financial institutions, but as mutuals, far removed from the business models used by plc banks. This distinction is sometimes overlooked by commentators. It can be demonstrated by the statement on major changes since FREDs 43, 44 and 45 at chapter 1.18(f): "The analysis also identified that disclosure requirements would need to be expanded for entities *seeking to generate wealth from financial instruments*. The ASB is proposing greater disclosure of the risks associated with financial instruments for financial institutions."

Building societies do not use financial instruments in the narrow definition of the word to generate wealth; building society law forbids them to take risk positions in commodities, currencies or derivatives. They are not in the business of offering complex structured transactions such as inheritance tax planning or involve themselves in opaque remuneration practices. Our meeting with the ASB in April 2012 revealed a potentially different understanding of "financial instruments". The ASB sees them in a much wider sense, including includes mortgages and savings products in the definition. It would be useful to have an official definition of the term. It would help us form a more meaningful opinion of the disclosures.

Building societies are incorporated and governed by the Building Societies Act 1986 (as amended in 1997) which requires societies to have as their main business the making of residential mortgage loans funded by the savings of members (customers), and describes how they are to be regulated in order to ensure that members' money is safe. Their business models are therefore simple and their members local.

We have long argued that EU-adopted IFRS is inappropriate for domestic financial mutuals such as building societies. Many international accounting standards cause the sector concern, in particular, IAS 39 and IFRS 7. It was therefore with relief that we greeted the announcement that the Accounting Standards Board had decided against requiring all financial institutions, regardless of size, to adopt IFRS.

Following that announcement, the ASB shared with the sector plans to increase disclosures for financial institutions, particularly in relation to financial instruments. On the whole, we welcomed these proposed disclosures: they were principles-based and therefore capable of being used in a proportionate way. **But we may revise this opinion in light of a recent meeting with the ASB when we discovered "financial instruments" may include mortgages and savings products in the definition. We propose to submit further comments in early May 2012.**

We consider the proposed additional disclosures in chapter 34.17 of draft FRS 102 are a fair reflection of the earlier ones and therefore endorse them. While the wording at chapter 34.22 on the analysis of financial instruments held at fair value has changed (the inputs are now subject to a hierarchy), we believe that the resulting three-way measurement remains the same.

Other changes such as the addition of information for credit, liquidity and market risk arising from financial instruments set out at chapter 34.24 appears excessive and unlikely to produce meaningful information for smaller financial institutions such as building societies. This is especially true if the definition of financial instruments has been widened to include mortgage and savings products. Lengthy complex disclosures could also confuse readers of societies' full accounts.

Question 3: Do you agree with the proposed scope for the areas cross-referenced to EU adopted IFRS as set out in section 1 of FRED 48? If not, please state what changes you prefer and why.

Answer 3: The Accounting Standards Board is proposing to align financial reporting requirements with company law and not proceed with a differential financial reporting framework based on public accountability. We support this move. It means that, if approved, the original proposals in FRED 48 will now apply to a broader group of entities than was considered when the IASB developed the IFRS for SMEs. Financial institutions form one such group; the other is firms with shares listed but not traded on a regulated market. It is for this latter category that the ASB has decided to cross reference four areas - earnings per share, interim financial reporting, operating segments, and accounting for insurance contracts – to the relevant EU-adopted international financial reporting standards. This is to help avoid introducing complexity into the proposals that would not apply to the majority of preparers, a move we commend. We do not comment on these cross referenced areas but request official confirmation that they will not apply to financial mutuals.

Question 4: Do you agree with the definition of a financial institution? If not, please provide your reasons and suggest how the definition might be improved.

Answer 4: A financial institution is defined by ASB as:

(a) a bank that is:
(i) a firm with a Part IV permission, which includes accepting deposits; and:
a. is a credit institution; or
b. whose Part IV permission includes a requirement that it complies with the rules in the General Prudential sourcebook and the Prudential sourcebook for Banks, Building Societies and Investment Firms relating to banks, but which is not a building society, friendly society or credit union; or
(ii) an EEA bank which is a full credit institution; or
(b) a building society as defined in section 119(1) of the Building Societies Act 1986 and incorporated (or deemed to be incorporated) under that Act; or
(c) an entity that undertakes the business of effecting or carrying out insurance contracts, including general and life assurance entities; or
(d) an investment trust, Irish Investment Company, venture capital trust, mutual fund, exchange traded fund, unit trust, open-ended investment company (OEIC), custodian bank or stockbroker; or
(e) a credit union, being a corporate body registered under the Industrial and Provident Societies Act 1965 as a credit union in accordance with the Credit Unions Act 1979, which is an authorised person; or
(f) an incorporated friendly society or a registered friendly society; or
(g) a retirement benefit plan.

We believe that the proposed definition of a financial institution is comprehensive and not in need of amendment. As we argue earlier, however, we suggest that the one-size-fits-all *application* of the definition should be refined to take into account the particular legal and financial characteristics of certain sectors, such as financial mutuals. For example, the ownership and structure of an investment trust or stockbroker differ greatly to those of a mutual such as a building society or credit union.

Building societies are incorporated and governed by the Building Societies Act 1986 (as amended in 1997) which requires societies to have as their main business the making of residential mortgage loans funded by the savings of members (customers), and describes how they are to be regulated in order to ensure that members' money is safe. Their business models are therefore simple and their members local.

Question 5: In relation to the proposals for specialist activities, the ASB would welcome views on:

(a) Whether and, if so, why the proposals for agriculture activities are considered unduly arduous? What alternatives should be proposed?
(b) Whether the proposals for service concession arrangements are sufficient to meet the needs of preparers?

Answer 5: No comment.

Question 6: The ASB is requesting comment on the proposals for the financial statements of retirement benefit plans, including:

(a) Do you consider that the proposals provide sufficient guidance?
(b) Do you agree with the proposed disclosures about the liability to pay pension benefits?

Answer 6: No comment

Question 7: Do you consider that the related party disclosure requirements in section 33 of FRED 48 are sufficient to meet the needs of preparers and users?

Answer 7: Section 33 requires disclosure of:

(a) the relationship between a parent and its subsidiaries;
(b) compensation of key management personnel, including all employee benefits; and
(c) transfers of resources, services or obligations between related parties regardless of whether a price is charged.

UK company law currently provides a disclosure exemption for transactions between wholly-owned subsidiaries, which the ASB proposes to retain unless the Accounting Directives are subsequently amended.

We understand that some respondents to the earlier consultation on UK GAAP argued that related party disclosures provided important information when considering the provision of finance to an entity. Few of our members provide traditional finance to entities – their main business is providing finance to individuals for mortgages - though a minority provide commercial mortgages. In these instances, they may require the information these disclosures contain. We therefore agree that these disclosures will help users of accounts.

Our only reservation is the definition of key management personnel as set out in section 33.6. We understand that any definition has to fit all entities but consider that in its current form, could lead to a variety of interpretations.

Question 8: Do you agree with the effective date? If not, what alternative date would you prefer and why?

Answer 8: The ASB is proposing that an institution will apply draft FRS 100, and draft FRS 101 or draft FRS 102 where applicable, for accounting periods beginning on or after 1 January 2015. Early application is permitted for accounting periods beginning on or after the date of issue of those standards.

We recognise that the ASB has decided to delay implementation of the new standard until IFRS 9, the replacement for IAS 39 on financial instruments, has been introduced. We welcome this move. But we believe there should be a period of stability before any transition. Agreement on IFRS 9, for example, is vital given the potential impact it has on profit figures. There is much benefit to be gained for smaller financial mutuals such as building societies to wait for the standard to be fully agreed, implemented and "bedded in" before applying it further. They need to work with a complete standard that is not just sound but stable. By delaying implementation, smaller institutions could gain "second mover advantage" by waiting for the larger players and their auditors to absorb and refine the new standard. We therefore consider it prudent to wait until at least two years after the current implementation date of IFRS 9, which we understand may itself be slipping.

Financial institutions are currently subject to unprecedented fundamental changes in regulation following the financial crisis – Basel III, Independent Commission on Banking, centralised clearing of OTC derivatives and EU-mandated reporting, to name but a few. A further delay in ending UK GAAP will not harm members or users of societies' full accounts but will reduce the burden on such institutions. It can therefore only be welcome. Finally, it is worth remembering that UK GAAP played no role in the current financial crisis.

Question 9 - Do you support the alternative view, or any individual aspect of it?

Answer 9 – There are aspects of the alternative view with which we have sympathy, in particular the concern about undue complexity and clutter in accounts.

We note the comment that the ASB's objective has been subverted by a subordination of users' information needs to "high-quality, understandable financial reporting", when it essentially should be taken as a given. As we argue earlier, users of building societies' accounts are in general not their savings and mortgage customers ie their owners. Their needs are catered for by the summary financial statement. The one stakeholder interested in the full accounts is the regulator, the Financial Services Authority. The FSA receives regular updates on the position of building societies (and banks and other firms) through regulatory returns and direct supervisory engagement.

We therefore believe that a slight refocus of the project to "providing users of accounts with the information they need" could be helpful to financial mutuals. It follows that we agree with paragraph 3.1 that says the ASB should have formed a view on the types of information that would be useful to the various groups of users of accounts which it has identified. Had that been the case for the building society sector, we consider that a more appropriate set of requirements on estimates of credit losses, effective interest rate and financial instruments could have been formulated. We note the alternative view's concern in paragraph 4.4 that MTM models fail to provide useful additional information in accounts, are hard to record and generate clutter.

30 April 2012