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Reclassification of Financial Assets under IAS 39: Impact on European Banks' Financial Statements

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Abstract

In response to the financial crisis, the IASB issued on 13 October 2008 an amendment to IAS 39 which enables entities to reclassify non-derivative financial assets held for trading and financial assets available-for-sale. This paper examines the influence of this controversial amendment on the 2008 financial statements of 219 European banks which apply IFRS. I find that approximately one-third of the sample banks have taken extensive advantage of these reclassification opportunities. The mean reclassification amount is 3.9% of total assets and 131% of the book value of equity, respectively. I further document that reclassifying banks avoid substantial fair value losses, and hence, report significantly higher levels of return on assets (ROA), return on equity (ROE), book value of equity and regulatory capital. In particular, the mean ROE switches sign from a negative ROE of −1.4% to a positive ROE of 1.3% due to gains from reclassifications. Overall, this paper documents a substantial impact of the

amendments on banks' financial statements and suggests analysing these reclassifications with particular caution.

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Notes

Financial assets available-for-sale (AFS) may be also reclassified to LAR if they would have met the definition of LAR at initial recognition and if the entity has the intention and ability to hold the financial asset for the foreseeable future or until maturity.

An analysis of the Committee of European Securities Regulators (CESR, 2009) finds a much higher proportion (i.e. 61%) of financial companies across Europe that used the reclassification option. However, the sample of CESR (2009) is substantially smaller (N = 100) and includes all financial companies whereas my sample covers banks only. Hence, the results of the studies can hardly be compared.

On 12 November 2009, the IASB issued the most recent revision IFRS 9 – Financial Instruments: Classification and Measurement which will be applicable for annual periods beginning on or after 1 January 2013, while earlier application is permitted.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction (IAS 32.11).

‘Fair value financial reporting is being blamed for the subprime meltdown, bank failures, the credit crunch, and the current recession. Global warming is about the only thing not being blamed on fair value and mark-to-market accounting. Before we're through, however, mark-to-market will probably be blamed for global warming, obesity, and the collapse of Detroit's Big three domestic automakers’ (King, 2009, p. 28).

At the time, US GAAP allowed reclassifications out of the trading category under rare circumstances (FAS 115, paragraph 15).

The regular procedures for consideration include a minimum three-month comment period, during which interested parties can comment on published exposure drafts.

The G20 leaders recommended that the Board take action by the end of 2009 to improve and simplify the accounting requirements for financial instruments.

Note that the following list is not exhaustive. See IFRS 7, paragraphs 12–12A, for a complete set of disclosure requirements concerning the reclassification of financial assets.

For the purpose of this paper, Europe is defined according to geographic criteria as defined by Reuters Knowledge.

Although the reclassification from AFS to HTM was allowed prior to the amendment to IAS 39, the effect on the financial statement is similar to the effect of a reclassification from AFS to LAR. I therefore include reclassifications from AFS to HTM in the present analysis.

When calculating the pre-reclassification regulatory capital ratios, I implicitly assume that the risk-weighted assets are not affected by the reclassification of financial assets. This assumption may be justified from an economic perspective, since the reclassification is an accounting change but not a change in the financial instruments' inherent risks.

For example, if a bank recognises a substantial loss in the year 2008, the book value of equity may also be reduced considerably. Therefore, the effect of such loss on ROE is higher than the effect using lagged (unaffected) equity for scaling purposes.

For example, due to the application of the amendments, the ROE of Pohjola Bank of Finland switches from −4.55% to 4.76%.

To define whether a bank has been directly supported by the government, I use Internet sources as well as a list provided by the Bank of International Settlements (2009) which distinguishes three types of direct government support, for instance, capital injections, debt guarantees and asset purchases.

In contrast, only 2.8% (4 out of 143) of the non-reclassifying banks were directly supported by the government.