The voice of banking
& financial services

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Dear Mr Grabowski,

Implementing the Recommendations of the Sharman Panel

This is the British Bankers' Association's response to the consultation on the above paper[1]. We welcome the opportunity to comment. In doing so, we consider the report from the perspective of banks as reporting entities and as lenders to British businesses.

Before commenting further, we must make clear that we believe the FRC should reconsider the approach it is taking to the implementation of the Sharman Recommendations. We fear that the decision to link the laudable aim of enhancing narrative reporting about liquidity and solvency risks to the going concern statement will be economically damaging to UK companies and will run the risk of confusing investors. The changes proposed represent a profound change to the existing UK framework and move to a point which diverges from current or anticipated international best practice.

As lenders to British businesses, our members are particularly concerned at the potential impact of the requirement for directors to 'obtain a high level of confidence about the entity's solvency and liquidity for the foreseeable future'. We anticipate this requirement will encourage directors to obtain assurance from their bank that financing arrangements will be renewed in future. We believe that giving such an assurance will amount to a commitment to lend. Under the Basel III rules, which are being implemented in the EU via CRDIV/CRR, banks must hold capital and liquidity against committed but undrawn facilities and will therefore be forced to charge for their provision. As such, it is highly likely that the proposed Guidance will result in additional costs to UK companies, perhaps by way of commitment fees. This is over and above the likely reduced ability of a company to access finance which would follow the qualification of the going concern statement were directors unable to meet the inappropriate redefinition of the going concern test and the wider impact on the UK economy that this would have.

In terms of the specific guidance for banks, we welcome the decision to confirm that the existence of central bank support for a solvent and viable bank does not necessarily constitute a material uncertainty. We note that the specific Guidance for banks appears inconsistent with the more general requirements. However, we agree that the additional prudential requirements taken together with the enhancements to the disclosure environment in which banks operate could be used to explain this difference. In particular, the risk disclosures recommended by the Enhanced Disclosure

[1] http://www.frc.org.uk/getattachment/f1b20d17-151f-49ec-a556-6756a4893205/Sharman-Implementation-Consultation-Paper.aspx

Task Force, which we support, are intended to provide the users of a bank's financial statements with an appropriate understanding of significant solvency and liquidity risks.

Our comments on the questions follow.

Question 1: Do you agree that the Guidance appropriately provides the clarification recommended by the Panel as to the purposes of the going concern assessment and reporting and is appropriate? If not, why not, and what changes should be made to the Guidance?

In general, we do not believe that the draft Guidance provides the clarification which was recommended by the Sharman Report. We fear that if adopted in its current form the Guidance will result in the majority of companies being unable to state that they are going concerns as it is difficult to foresee circumstances in which a board will be in a position to obtain a 'high level of confidence about the entity's solvency and liquidity for the foreseeable future'. Furthermore, we believe that investors will find the resultant additional disclosure confusing. That being said, we are broadly content with the supplementary guidance for banks. As such, we believe the FRC should give further consideration to the proposed Guidance and how the Sharman recommendations can be built in to the 2009 guidance.

Question 2: Do you agree with the description in the Guidance of when a Company should be judged to be a going concern? Do you agree in particular that this should take full account of all actions (whether within or outside the normal course of business) that the board would consider taking and that would be available to it; and that, if the underlying risks were to crystallise, there should be a high level of confidence that these actions would be effective in addressing them? Is the term 'a high level of confidence' sufficiently understandable? If not, why not, and how should the description or term be modified?

We fundamentally disagree with the proposed description for a number of reasons.

We believe that the going concern status of an entity can only be judged to a high level of confidence if that assessment is made on a point in time basis or over a short horizon. This is not to say that entities should not disclose longer term risks but it is not realistic to expect directors to assess to a high level of confidence risks which may emerge over a longer horizon or in the 'foreseeable future' or for this to lead to qualification of the going concern statement. Furthermore, it is unrealistic to expect directors to be in a position ascertain whether the steps taken to mitigate longer term risks would be effective.

From a practical perspective, we believe that the Guidance will lead directors of companies to seek assurance from their lenders that bank financing arrangements will be renewed in the future. Under the Basel II regulatory capital framework, however, banks incur an additional capital charge for providing such irrevocable loan commitments and can therefore only do so for a fee. Similarly under the Basel III quantitative requirements for liquidity banks will be required to hold a stock of High Quality Liquid Assets against the possibility that a committed credit line may be drawn during a period of financial stress. These requirements are described more fully in annex 1. There is a risk therefore that the proposals will result in an additional cost to UK companies as directors seek the comfort of such statements to satisfy the high hurdle set by the draft Guidance. It is also likely in our view that directors will respond to this by holding even more cash than they do now precisely at a time when government efforts are designed to encourage corporates to invest.

Question 3: Do you agree with the approach the Guidance takes to the implications and nature of actions within or outside the normal course of business? Do you consider that the Guidance explains their nature sufficiently clearly? If not, why not and what changes should be made to the Guidance?

The definitions are clear but the Guidance on how they should be applied is not, to the degree that we recommend the distinction between the two is dropped. As we understand it, the overriding factor in the Guidance is that the directors obtain a high level of confidence on the actions required regardless of whether they are within or outside the normal course of business.

Question 4: Do you agree with the approach taken to interpreting the foreseeable future and is this sufficiently clear in the Guidance? If not, why not and how should the Guidance be changed?

As explained by our response to question 2, we do not agree with the proposed approach. Nevertheless, if it is to be adopted we would recommend that the interpretation be subjected to meaningful road-testing.

Question 5: Do you agree that the use of the term 'going concern' in the phrase 'going concern basis of accounting' is sufficiently clearly distinguished in the Guidance from its use in the Code requirement for a statement that the company '<u>is</u> a going concern' and from its use in the accounting and auditing standards in the context of material uncertainties about the company's ability to continue as a going concern? Is it clear from the Guidance that the statement the directors are required to make under the Code (that the Company is a going concern) should reflect the board's judgement and is not intended to be absolute? If not, why not and what charges should be made to the Guidance or the Code requirement?

We do not believe the Guidance provides a clear distinction of the terms and would add that if adopted could further exacerbate the expectation gap by bringing further confusion as to the meaning of going concern.

Question 6: Do you agree that the judgemental approach in the Guidance to determining when there are material uncertainties to be disclosed is the appropriate interpretation of the relevant accounting standards? Do you agree that the factors and circumstances highlighted respectively in paragraphs 2.30 and 2.31 are appropriate? If not, why not and what charges should be made to the Guidance?

We disagree with the approach taken in the Guidance to determining material uncertainty. We note that the definitions used under 2.29 and 2.30 are inconsistent and do not believe that either one is consistent with current UK practice nor the international consensus.

As mentioned above, we also find it inconceivable that a board will be in a position to obtain a high level of confidence about the entity's solvency and liquidity for the foreseeable future and therefore believe that if adopted the Guidance will result in the vast majority of audit opinions including an emphasis of matter. We encourage the FRC to engage with the IASB to develop an appropriate way forward.

Question 7: Do you agree that the interpretations adopted in the Guidance in implementing Recommendation 2(b) are consistent with FRS 18 and ISA (UK and Ireland) 570? If not, why not and what changes should be made to the Guidance or those standards?

We believe that Recommendation 2(b) is intrinsically linked to Recommendation 2(a) that the FRC should engage with the IASB and IAASB to achieve a common international understanding, which we fully support. So we are disappointed that the draft Guidance clearly demonstrates that this is not the case as it departs significantly from the direction we believe the IASB is taking with regard to IAS 1. We therefore strongly recommend that the FRC waits for the IASB to complete its project.

Question 8: Do you agree that Section 2 of the Guidance appropriately implements Recommendation 3? Do you agree with the approach to stress tests and the application of prudence in conducting them? Do you agree with the approach to identifying significant solvency and liquidity risks? Do you agree with the description of solvency and liquidity risks? If not, why not and what changes should be made to the Guidance?

We do not support the manner in which Section 2 seeks to implement Recommendation 3. Whilst the proposed Guidance might have some value in the context of risk disclosures we do not believe it is appropriate for purposes of making the going concern assessment.

Question 9: Do you agree that the approach taken in Section 4 of the Guidance in implementing the disclosures in Recommendation 4 is appropriate? Is the term 'robustness of the going concern assessment process and outcome' sufficiently clear? Do you agree that the approach the board should adopt in obtaining assurance about these matters is appropriately reflected in Section 3 of the Guidance? Do you agree that the board should set out how it has interpreted the foreseeable future for the purposes of its assessment? If not, why not and what changes should be made to the Guidance?

We do not support the use of the term 'robustness' as it lacks a clear definition. We recommended that the Guidance be focused upon the existing standard of care within the Companies Act 2006.

Question 10: Do you agree that the proposed amendments to the auditing standards appropriately implement the enhanced role of the auditor envisaged in Recommendations 4 and 5? If not, why not and what changes should be made to the auditing standards?

Our understanding of the Sharman Recommendations was that the FRC was directed to seek international consensus for changes to auditing standards not to adopt unilateral changes to UK auditing requirements which diverge from ISAs. On this basis, we cannot support the proposed amendments and encourage the FRC to engage with international peers and the IAASB as recommend by the Sharman Panel.

Question 11: Do you agree that it is appropriate for the Supplement to confirm that central bank support for a solvent and viable bank does not necessarily constitute a material uncertainty? In particular, do you agree that central bank support (including ELA) may be regarded as in the normal course of business where the bank is judged to be solvent and viable? Do you agree that the approach set out in the Supplement to assessing whether there is a material uncertainty is appropriate and consistent with the general approach in the Guidance? If not, why not and what changes should be made to the Supplement to the Guidance?

We agree that it is entirely appropriate for the Guidance to stipulate that the use of central bank support does not of itself constitute a material uncertainty.

Question 12: Do you consider the proposed implementation date to be appropriate? If not, why not and what date should the application date be?

Notwithstanding our significant reservations over the content of the Guidance, we do not believe it is realistic or appropriate to require implementation over the proposed timeframe. For many entities this requires application within the current reporting period which is wholly inappropriate given the significance of the change and the potential impact. Were the Sharman recommendations to be implemented as currently proposed, which we do not believe they should be, they should come into effect only after directors have been given an appropriate period to review the requirements of the final requirements.

Question 13: Do you believe that the Guidance will deliver the intended benefits? If not, why not? Do you believe that the Guidance will give rise to additional costs or any inappropriate

consequences? For example, as compared with the 2009 Guidance, do you believe that the Guidance will give rise to fewer companies being judged to be a going concern and/or more companies disclosing material uncertainties? If so, what are the key drivers and can you give an estimate or indication of the likely cost or impact? Do you believe that such additional costs or impact would be justified by the benefits?

Overall, we do not believe the Guidance will deliver the intended benefits for the reasons outlined above. Furthermore, we believe that the Guidance may result in additional costs for business which request what will effectively be irrevocable medium term loan commitments from their lenders. That being said, we believe the supplementary Guidance for banks achieves the objective set for it.

Question 14: Do you agree with the approach to SMEs in the Guidance? If not, why not and what changes should be made to the Guidance?

The Guidance does not appear to be appropriate for SMEs. We consider that the Guidance would constitute a disproportionate burden for SMEs that already labour in the UK under a significant and disproportionate regulatory burden. We encourage the FRC to consider the development of separate requirements for SMEs which are more in keeping with their size and complexity.

Question 15: Are there any other matters which the FRC should consider in relation to the Guidance and the Supplement? If so, what are that and what changes, if any, should be made to address them?

We have no further comments.

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Annex

A description of the capital and liquidity requirements relating to the provision of committed but undrawn credit facilities by banks to corporate borrowers

Capital requirements

The capital requirements for banks relating to committed but undrawn credit facilities to corporate borrowers are described in the Basel Committee's '*International Convergence of Capital Measurement and Capital standards'*[2], commonly known as Basel II.

Basel II offers two alternative approaches – standardised or internal ratings based - to the treatment of such undrawn facilities.

The standardised approach

Paragraphs 82 and 83 require banks to apply a 20% credit conversion factor (CCF) to commitments with an up to one year and a 50% CCF to commitments of over one year. We believe the proposals in the Sharman proposals implementation paper would require the application of a 50% CCF

The Internal Ratings-Based approach

The Internal Ratings-Based (IRB) approach permits banks to use internal models to quantify their exposure at default, which must include an internal estimate, based on their experience, of a CCF in accordance with paragraphs 311 to 316.

Liquidity requirements

The liquidity requirements for banks relating to committed but undrawn credit facilities to corporate borrowers are described in the Basel Committee's '*Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools'* [3]. These are in the course of being introduced, but when fully implemented will require that banks hold a stock of High Quality Liquid Assets (HQLA) against the possibility that at corporate borrower may draw down on a committed line during a period of financial stress. This requirement is know as the Liquidity Coverage Ratio.

Paragraph 131 requires a banks to assume that 10% drawdown of the unused portion of any committed credit facility extended to a non-financial corporate and hold HQLAs against this.

[2] http://www.bis.org/publ/bcbs128.htm
[3] http://www.bis.org/publ/bcbs238.htm