

Second Global IFRS Banking Survey – Q1 2012 *A changing landscape*



Global banks react to developing
accounting reform

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Foreword

As the ongoing financial crisis, which began more than four years ago, continues to dominate the banking agenda, the shape and direction of new regulatory and accounting reforms is becoming clearer. Effort continues to be expended on the development of an entirely new financial instrument accounting standard. Whilst some areas have been formulated more clearly, others still require considerable attention. Despite this progress, the implications of these changes are not yet clear.

Deloitte* Global Banking Industry leaders have spent a significant amount of time consulting with clients, their regulators and those involved with the development of these standards.

Over the last few months the Deloitte Touche Tohmatsu Limited (DTTL) Global Financial Services Industry (GFSI) group has gathered the latest thoughts of 56 major banking groups on the topic of accounting change. As a result of the efforts of a large number of individuals and member firms, the DTTL GFSI group is delighted to present to you the findings from the second Global IFRS Banking survey. We hope that this survey will provide you with insights into the current thinking across the industry and stimulate discussion, both within your institution and with other key stakeholders.

This is the second in a series of surveys in relation to IFRS for banks which we will revisit on a regular basis over the coming years as standards are finalised and the process of implementation begins. We believe that the survey results and findings will serve as a mechanism for informing and developing market consensus on the technical and operational challenges and the practicalities and implications of these new rules.

We are extremely grateful to all the institutions and individuals who have contributed to this survey and we would warmly welcome feedback and any suggestions you may have for our follow up efforts in this area.

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* As used in this survey,
"Deloitte" means Deloitte
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member firms

Introduction

The changing accounting landscape represents one of the biggest medium term challenges for banks. Outside of immediate market challenges and alongside the wider regulatory reforms currently being implemented or planned, preparing for the implementation of the new IFRSs is the start of what is expected to be a large scale change programme.

Background

The IASB¹ and the US FASB², ('the Boards') spurred on by the G20 and regulatory bodies, have set about reworking the key accounting standards that apply to banks following the financial crisis. The replacement of IAS 39 with IFRS 9 promises to be the biggest change in banks' financial reporting since the introduction of IFRSs. In addition, other areas of the accounting rules, such as those relating to consolidation, have also been revised.

IFRS 9 remains a work in progress. Some parts are complete, some parts previously considered complete are potentially being revisited and some parts are still being developed. Following the two year deferral of the IFRS 9 mandatory effective date (agreed in December 2011 by the IASB), what appears certain is that banks and other entities that are required or permitted to apply IFRS will be required to apply IFRS 9 in 2015. For entities in the EU, there is the additional uncertainty over the timing of EU endorsement.

Whilst the final text is still being developed, banks are starting to assess the likely impact of these rules and to plan for their implementation. Other standards such as IFRSs 10, 11, 12 and 13 have been finalised and are in the process of being implemented by many institutions to comply with a 1 January 2013 effective date.

Development of the proposed reforms

Impairment

Since the DTLG GFSI group published the first Global IFRS Banking Survey³ in August 2011, the Boards have had numerous meetings in an effort to reach a consensus on their final proposals on impairment. The accounting for loan losses has dominated the agenda of both Boards as most commentators, and the Boards themselves, regard it as critical that they achieve convergence for this part of the financial instruments project.

In early autumn 2011 the Boards looked increasingly at odds, with some major conceptual differences between them that each Board was struggling to overcome. Since then progress has been made and with each new joint Board meeting, the Boards appear to be moving towards an agreement and consequently the shape of the new impairment requirements is becoming clearer.

1 International Accounting Standards Board

2 Financial Accounting Standards Board

3 http://www.deloitte.com/view/en_GB/uk/industries/financial-services/sector-focus/retail-banking/a6f1d00f62161310VgnVCM2000001b56f00aRCRD.htm

At the date of writing, the Boards' current thinking for the impairment model can be summarised as follows:

Financial assets that are debt instruments, e.g. debt securities, loans, receivables (collectively referred to as "loans") that are subject to impairment accounting will be stratified into three categories, or 'buckets', and depending in which bucket they reside, will drive the calculation of the impairment provision.

	Credit characteristics of the financial asset	Basis for impairment provision
Bucket 1	All originated loans and non-distressed purchased loans start in Bucket 1 at initial recognition.	The provision will equal the portion of lifetime expected losses arising from loss events expected to occur over the next 12 months.
Bucket 2	Loans evaluated on a <i>group portfolio</i> basis move from Bucket 1 to Bucket 2 when "there is a more than insignificant deterioration in credit quality since initial recognition and the likelihood of default is such that it is at least reasonably possible that the contractual cash flows may not be recoverable." ⁴ Certain purchased distressed assets may start in Bucket 2.	Full lifetime expected losses. For certain distressed assets recognised initially in Bucket 2 the provision will reflect the change in full lifetime credit losses since acquisition.
Bucket 3	Loans move from Bucket 2 to Bucket 3 when they are evaluated on an <i>individual basis</i> and there is a significant deterioration in credit quality since initial recognition and the likelihood of default is such that it is at least reasonably possible that the contractual cash flows may not be recoverable. Certain purchased distressed assets may start in Bucket 3.	Full lifetime expected losses. For certain distressed assets recognised initially in Bucket 3 the provision will reflect the change in full lifetime credit losses since acquisition.

Financial assets will move from Bucket 1 to Bucket 3 (with the exception of some purchased distressed assets that may start in Bucket 2 or 3) based on the deterioration in credit risk since the asset was initially recognised. To represent the three buckets the phrase "the good, the bad and the ugly" has been coined by some standard-setting staff.

Proportion of expected losses approach	Lifetime losses approach	
Bucket 1 – Good Book Expected losses arising from loss events in the next 12 months.	Bucket 2 – Bad Assessed on a portfolio basis	Collective ↕ Specific
	Bucket 3 – Ugly Assessed on a specific basis	
Good ←————→ Bad		

In order to apply the three bucket approach a bank will need to determine:

- lifetime expected losses based on a probability weighted approach, both at initial recognition and every reporting date thereafter; and
- the various loss events that are expected to occur in the next 12 months, assigning probabilities to those events, and determining what expected loss would arise from those loss events. This will be required at initial recognition and thereafter for all loans (except certain purchased distressed assets) that have not yet met the trigger point to move to Bucket 2 or Bucket 3.

The model will also have the effect of recognising full lifetime losses for loans that mature within 12 months, whether they are originated or are acquired with a maturity of less than 12 months, or a longer-term loan that simply has less than 12 months until it matures.

In December 2011 it became clear that the IASB would consider looking again at certain aspects of classification and measurement in IFRS 9.

Classification and measurement

For a number of months questions have been asked about whether the classification and measurement requirements for financial assets and financial liabilities that were finalised in 2010 would be revisited. In December 2011 it became clear that the IASB would consider looking again at certain aspects of classification and measurement in IFRS 9. The IASB has chosen this route for a number of reasons. First, certain aspects of the amortised cost criteria have proved challenging to implement and the IASB wishes to take the opportunity to improve these aspects. Second, the implementation date for accounting for insurance contracts (IFRS 4 phase II) is approaching and the combination of this and IFRS 9 could lead to considerable income statement volatility for insurers due to the different measurement bases for financial assets and insurance liabilities. Third, the FASB are getting close to finalising their thinking on classification and measurement, which in a number of significant respects differs from IFRS 9. It is too early to determine what the outcome of this debate may be but the IASB have identified three areas they will consider:

- whether to add further guidance in IFRS 9 to clarify what terms of an instrument are acceptable to achieve amortised cost classification;
- whether to bifurcate embedded derivatives in financial assets (something IFRS 9 currently prohibits); and
- whether to expand the use of the “other comprehensive income (OCI)” model to include a wider class of assets or to introduce a third business model for some debt instruments (e.g. for listed debt securities that would currently be measured at amortised cost under IFRS 9).

Over the coming months the preferences of each Board and the timing of potential amendments should become clearer.

Background to the survey

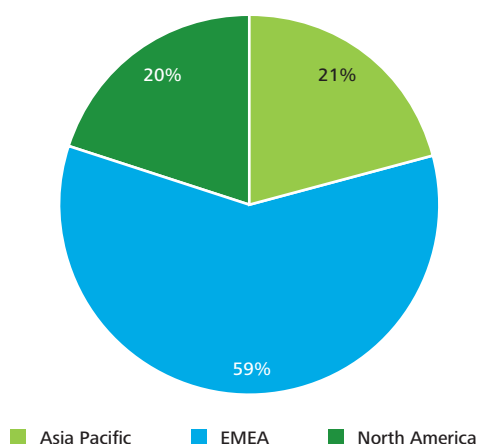
This survey was undertaken in order to:

- help the industry better understand and to raise awareness of the size and scale of the impact of the proposed changes;
- assist the industry in preparing for and planning for implementation; and
- help the accounting profession begin to prepare for the challenges that may occur in auditing bank financial statements under the new rules.

Deloitte sought to achieve a global reach with the survey by requesting responses from a large number of institutions in different geographies and has received responses from 56 banks across Europe, the Middle East & Africa, Asia Pacific and North America. Responses received included 19 of the 29 global systemically important financial institutions determined by the Financial Stability Board and half of the top 50 global banking groups measured by total assets listed in the The Banker Top 1000 World Banks 2011. In most instances, responses have been co-ordinated from the accounting policy or finance areas although many respondents have sought the views of other key areas of the bank such as the credit risk department. Of the responses received, 31 participants took part in the previous edition of the survey.

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Figure 1. Geographical spread of respondents



Given the current state of development of the rules and the desire to obtain clear, comparable and useful information in the responses, this survey did not seek to obtain feedback on particular technical features of the rules. The focus has been to draw out views in relation to the high level impacts and expectations based on current proposals. As a result, 32 questions relating to the following topic areas were selected:

- awareness and high level impact;
- IFRS 9 – timetable, endorsement and convergence;
- IFRS 9 – classification and measurement and hedge accounting;
- IFRS 9 – impairment accounting;
- IFRS 9 – product pricing and capital implications;
- IFRS 9 – impact on financial statements;
- IFRS 9 – implementation; and
- IFRSs 10, 12 and 13.

The survey has provided interesting comparative data that is being fed back to participants to assist in their preparations for the new accounting regime. The intention is to follow this survey with a further iteration, once more clarity has been obtained on the final text of IFRS 9 and market participants have been able to assess the likely impact.

Summary of key findings

When comparing the results of this survey with our previous survey, contributors are much more confident that the industry can meet the requirements of IFRS 9 but are not persuaded that IFRS 9 will provide more useful information.

Awareness and impact

When comparing the results of this survey with our previous survey, contributors are much more confident that the industry can meet the requirements of IFRS 9 but are not persuaded that IFRS 9 will provide more useful information. Respondents currently believe that IFRS 9 will (i) less accurately reflect the results of their organisation and (ii) will increase the volatility of reported earnings. Despite this, a higher proportion of contributors rated accounting change as having a major impact on their institution and a higher level of board and audit committee engagement was noted when compared to last year's survey.

Impairment deliberations

Whilst many contributors preferred an impairment model based on credit risk at the measurement date, the majority of respondents thought that an impairment model based on deterioration of credit risk is operationally feasible. As such, the proposed three bucket model is likely to be implemented. However, in detail, many aspects of implementation remain of concern. One of the major concerns raised was tracking the credit quality of loans from origination or purchase, especially at a loan level, as this is likely to be operationally complex and system intensive. Respondents also emphasised the impact that the proposed rules will have on corporate and small and medium-sized enterprise (SME) lending, because of implementation challenges and the magnitude of the impairment provision uplift.

Capital impact

Half the respondents expect the new rules to affect pricing with an even greater proportion predicting an increase in capital requirements. Those who predicted increases to capital requirements made estimates ranging from zero to over 20% of current levels, with the majority expecting an increase in capital requirements of up to 10% in order to maintain current capital ratios on transition. The majority of those who did not expect capital requirements to increase believed that regulatory capital rules would eliminate the effect of the accounting changes (e.g. impairment charges would be added back).

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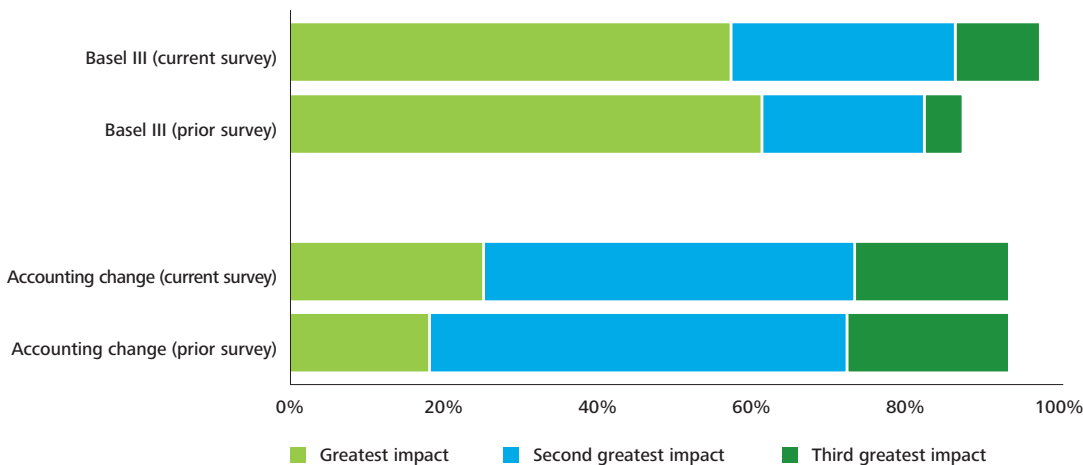
Standard finalisation and implementation

The key challenge to finalisation of IFRS 9 is achieving a macrohedging solution. However, contributors believe that a solution can be found. Whether it is worth delaying EU endorsement of the whole project until the solution is agreed is questionable, albeit many respondents would prefer such a delay. Whilst this is expected to slow a significant portion of the implementation projects of institutions based in the EU, almost two thirds of respondents will have started their implementation projects by the end of 2012. This is because an overwhelming majority of respondents expect that two years or more will be required to complete implementation, a reflection of both the complexity and the operational challenges of the standard. The decision not to require restated comparatives on adoption buys valuable implementation time. However, many contributors are concerned that one leading bank disclosing the impact of the new impairment model prior to the effective date of the new standard will force early disclosure of the likely effect of the changes across the industry and thereby negate some of the benefit of not having to restating comparatives.

As the 2013 implementation date of IFRSs 10 and 12 draws closer, it was surprising that approximately a third of respondents have not yet started their project to implement IFRS 10 and IFRS 12, and thus are not yet sure about the impact of these standards. For those who have are in the process of implementing IFRSs 10 and 12, the challenge common to both is the availability and access to data, particularly in relation to the new requirement for disclosure of unconsolidated structured entities.

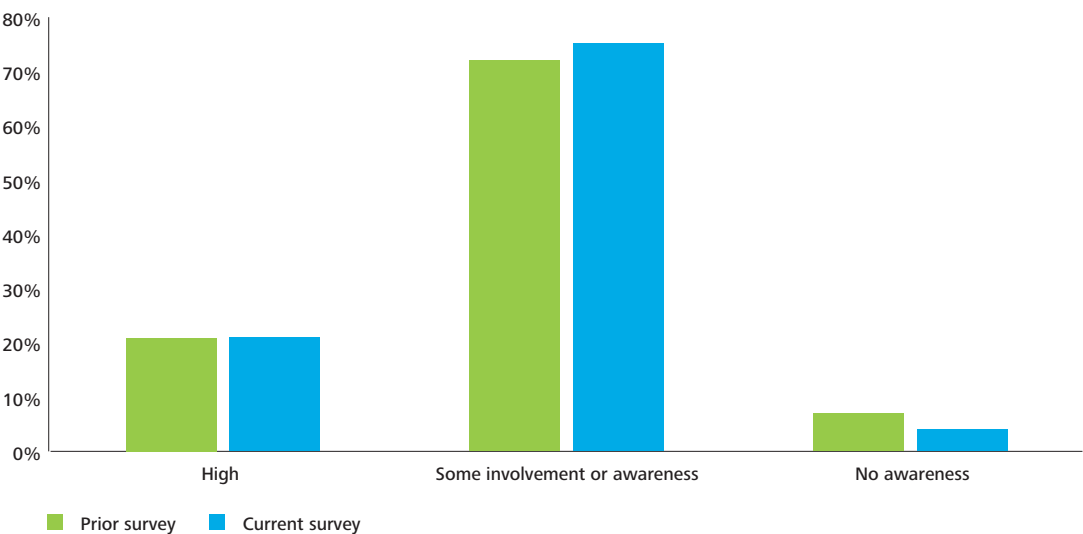
Awareness and high level impact

Figure 2. In order, which of the following do you expect to have the greatest impact on the organisation over the next 5 years?



Regulatory change remains at the top the agenda for banks and is equally, if not more important now, than when last year’s survey was conducted. Despite key dates for the application of both IFRS 9 and Basel III being pushed back, they remain very much on the strategic agenda for banks’ senior management.

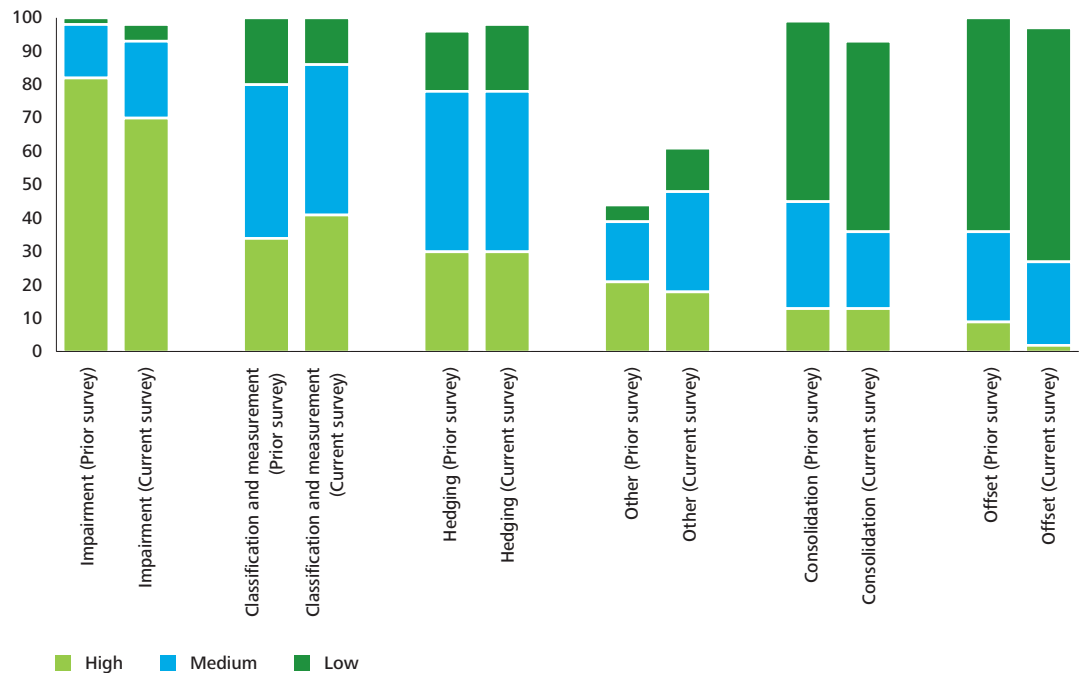
Figure 3. How would you categorise the current level of involvement/awareness of upcoming accounting change at board and audit committee level?



Respondents’ boards show a consistently high level of concern and interest in accounting change.

The degree to which accounting change has been communicated at board and audit committee level within organisations is encouraging. Respondents’ boards show a consistently high level of concern and interest in accounting change. However, as expected, there are fewer banks where there is no board or audit committee involvement as the application date of the new rules approaches.

Figure 4. In relation to accounting change, which of the following do you believe will have the greatest impact on your business model and/or financial statements?



As with the prior survey, impairment still dominates the list of accounting changes as this is where the greatest impact on financial statements is expected for banks. However, in the detail, classification and measurement has edged up as a concern, whilst impairment has edged down. Since the IASB and FASB finalised their amendments to offset, this has virtually ceased to be an issue of high interest.

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Figure 5. Do you believe the industry as a whole can meet the requirements of IFRS 9 to an adequate level, whilst still maintaining comparability?

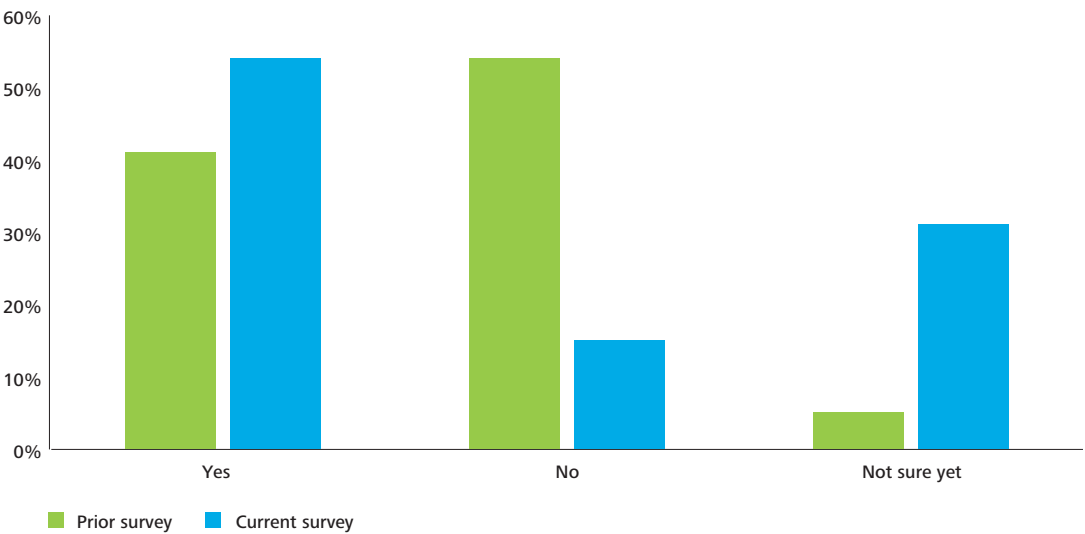
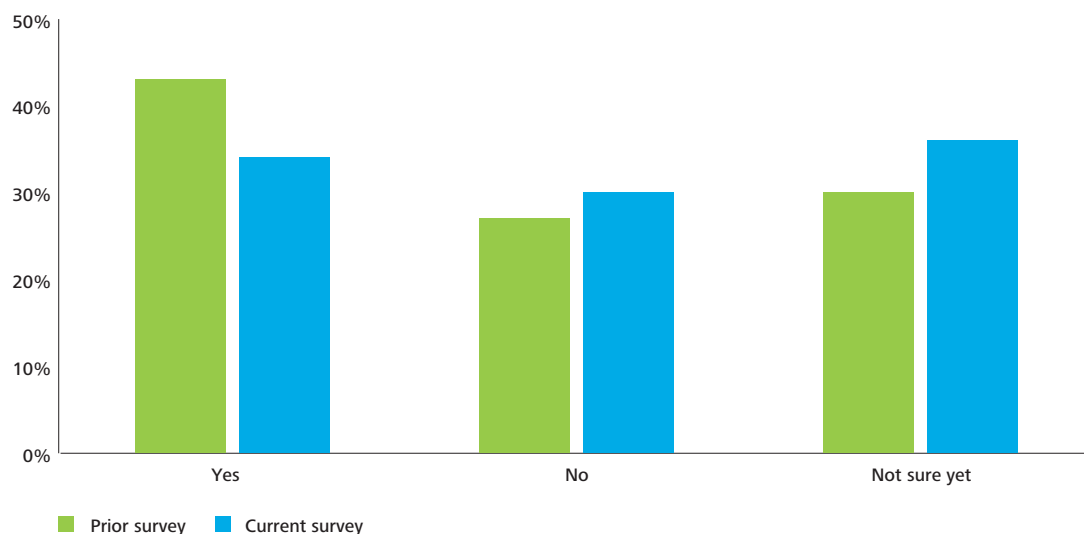


Figure 6. Do you believe IFRS 9 will improve the usefulness of the financial statements relative to their current status under IAS 39?

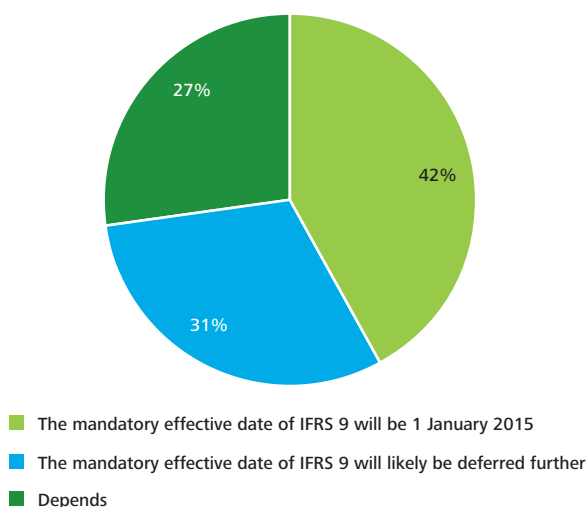


One of the key objectives of the IAS 39 replacement project is to reduce complexity while improving the usefulness of financial statements. Respondents believe that recent developments have made IFRS 9 easier to comply with since the previous survey with a 32% increase (from 41% to 54%) in the number of respondents who think they can do this whilst the number of respondents who think they cannot do this have decreased by 72% (from 54% to 15%). However, there has been a significant reduction (43% to 34%, representing a 21% decrease) in the number of respondents that thought IFRS 9 would lead to increased usefulness of financial statements. It appears that the IASB still has some way to go in convincing banks that the new standard is an improvement on IAS 39.

IFRS 9 – Timetable, endorsement and convergence

Whilst the mandatory effective date has been pushed back to 1 January 2015 and respondents are generally working towards implementation on that assumption, many participants believe that the timeline might be deferred further depending on the pace of progress on impairment and macro hedging rules, convergence with the US FASB and European Union (EU) endorsement for banks listed in the EU.

Figure 7. The IASB has agreed to defer the mandatory effective date of IFRS 9 to 1 January 2015. Do you think the mandatory effective date will be deferred further?



Some of the uncertainty reflects banks' concern at the pace at which the IASB is addressing the reforms to macro hedge accounting (see figure 13).

Some of the uncertainty reflects banks' concern at the pace at which the IASB is addressing the reforms to macro hedge accounting (see figure 13). It is of note that since the banks responded to the survey the IASB have revisited their timetable for issuing the exposure drafts. At the time of writing, further exposure drafts on classification and measurement and impairment are expected in Q3/Q4 2012 with a discussion paper or exposure draft on macro hedge accounting expected in Q3 2012.

Figure 8. Do you expect to provide pro-forma information showing restated comparatives for investors even though it is not required by the standard?

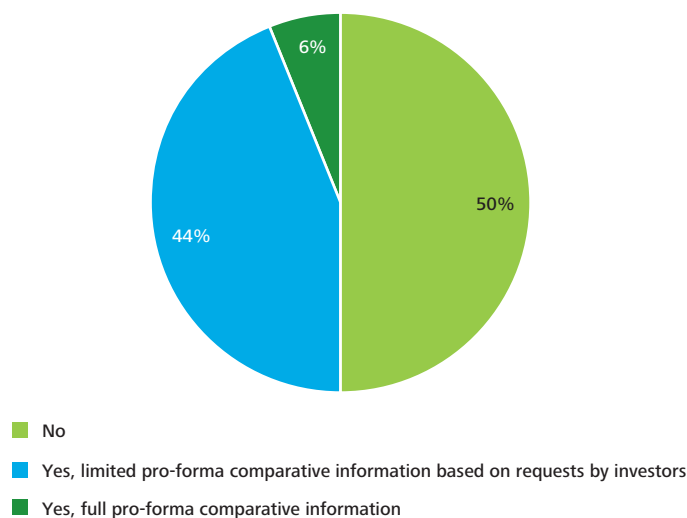
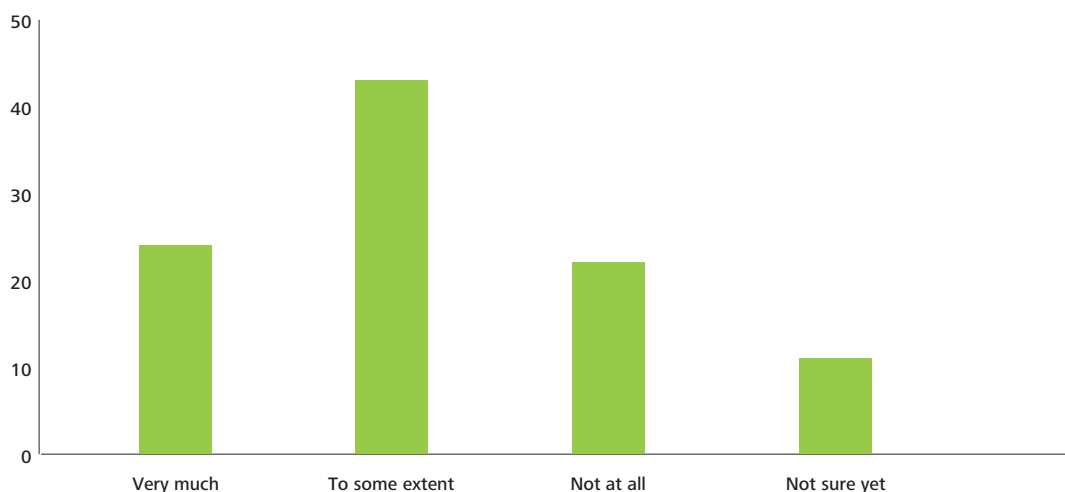


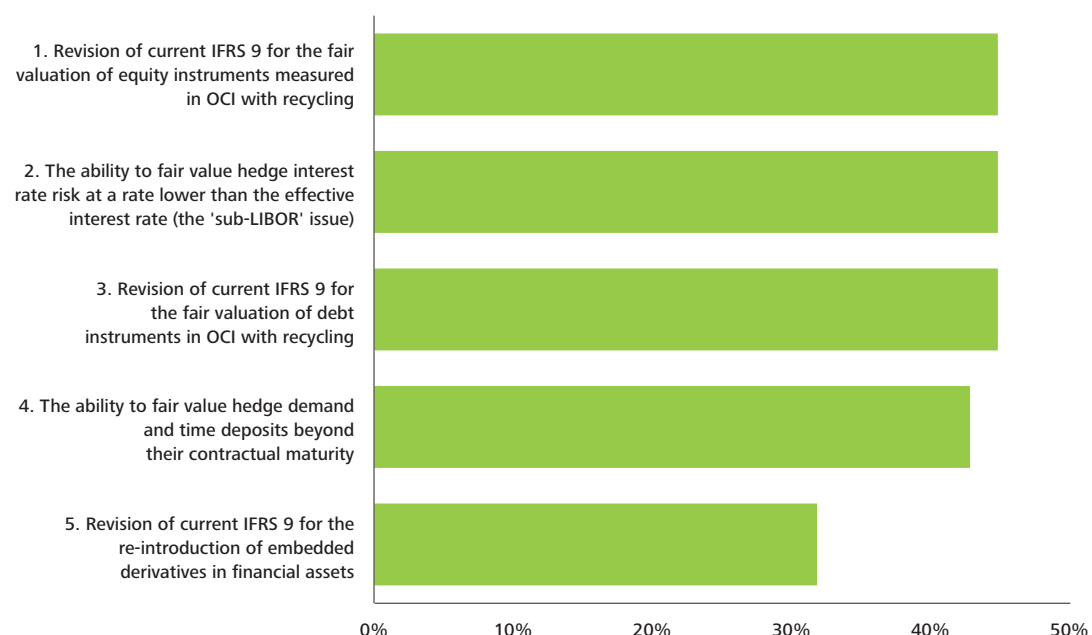
Figure 9. How much would the early adoption of your peer group influence your decision to adopt early?



Few respondents believe that full pro-forma comparative information will be required by investors. However, this will depend on local regulation in certain areas and, in particular, will be influenced by what competitors report. Accordingly, respondents' views were mixed. Where local regulation does not play a major role, peer groups are expected to have a strong influence on early adoption decisions.

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Figure 10. Which of the following areas do you believe the IASB should reconsider in order to have your support for the new financial instruments accounting standard?

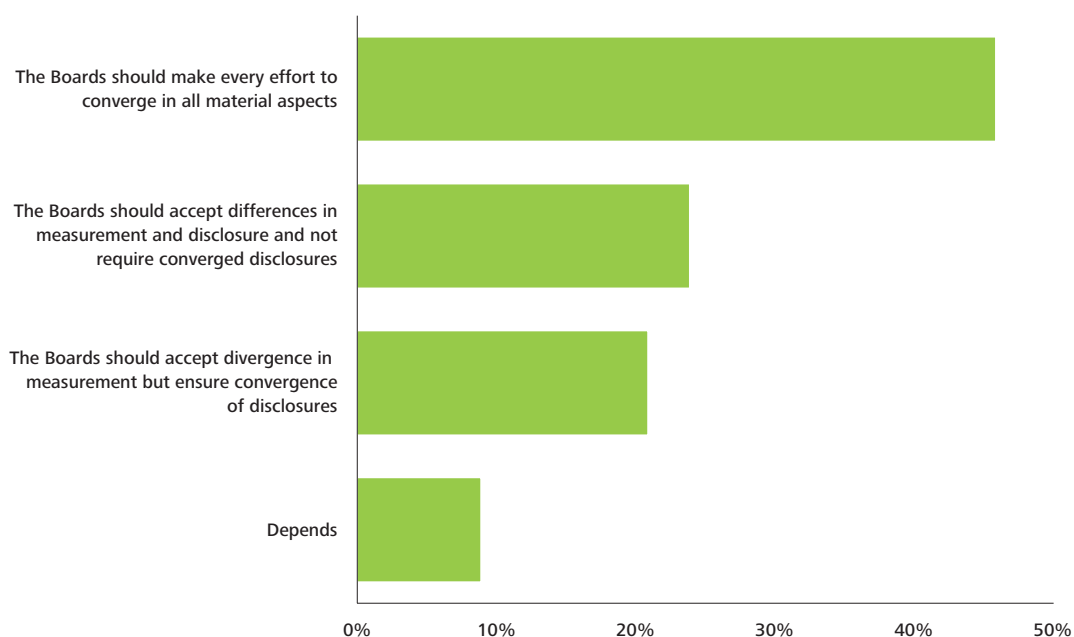


When respondents were asked which of a specific list of contentious issues in IFRS 9 they would want resolved in order to get their support for IFRS 9 (each of which is explained in the box below), the majority felt that the IASB should consider resolving these issues in order to get their support but without a clear consensus as to which should be the priority. The fair valuation of debt instruments in other comprehensive income and the reintroduction of embedded derivatives for financial assets have since been included on the IASB's agenda.

1. Allowance for equity instruments to be measured at fair value through equity with gains and losses being recycled to profit and loss on disposal and impairment.
2. It is common for banks to swap sub-LIBOR fixed rate instruments into sub-LIBOR floating rate instruments using interest rate swaps. Allowing fair value hedge accounting for these hedges would reflect this risk management strategy.
3. Change that would retain current accounting in IAS 39 for available-for-sale debt instruments.
4. Accommodating banks who hedge economically by viewing 'on demand' deposits as long term fixed rate deposits based on past behaviour.
5. Reintroducing on an optional basis current IAS 39 requirements to separately fair value certain embedded derivatives in financial assets.

Figure 11. In cases where the IASB and FASB disagree on the financial instruments proposals, what is your preference for the route the Boards should take?

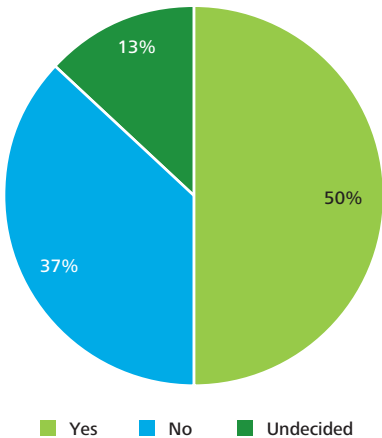
Convergence of financial instruments accounting between the IASB and the FASB is expected to be a lengthy process, but 46% of respondents favour full convergence in all material aspects.



Convergence of financial instruments accounting between the IASB and the FASB is expected to be a lengthy process, but 46% of respondents favour full convergence in all material aspects. However, a significant number of respondents believe that divergence should be accepted in respect of measurement and even disclosures.

IFRS 9 – Classification and measurement and hedge accounting

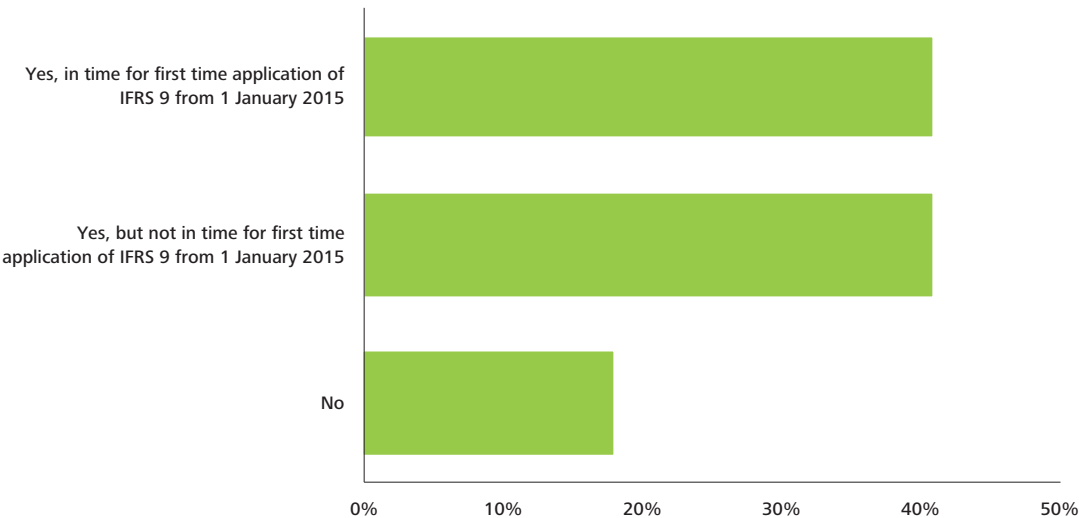
Figure 12. For your financial institution, do you expect that more financial instruments will be measured at fair value under IFRS 9 than under IAS 39?



Half of respondents believed that more financial instruments will be held at fair value under IFRS 9 compared to IAS 39 (and thus result in more volatility) whilst 37% thought the opposite and 13% were undecided.

The financial institutions that took part in this survey have diverse balance sheets and business models, and thus respondents views were mixed. Half of respondents believed that more financial instruments will be held at fair value under IFRS 9 compared to IAS 39 (and thus result in more volatility) whilst 37% thought the opposite and 13% were undecided.

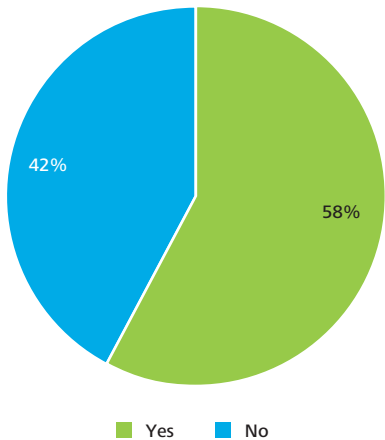
Figure 13. Do you think the IASB will develop a replacement of the IAS 39 macro fair value hedge accounting model for interest rate risk that will be welcomed by preparers and the European Commission who would endorse the standard for use in Europe?



The challenge of achieving a macro hedging solution remains but 82% of contributors are confident that the IASB can develop a solution that will be welcomed by banks. However, respondents' views on whether the design of the macro fair value hedge accounting model would be finalised in time for application by the 2015 mandatory effective date were evenly split. This uncertainty is also reflected in figure 7 where many respondents were of the view that the standard will be deferred further than the current expectation (2015).

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Figure 14. Do you think the European Commission should wait for a satisfactory replacement of the IAS 39 macro fair value hedge accounting model for interest rate risk before endorsing IFRS 9?

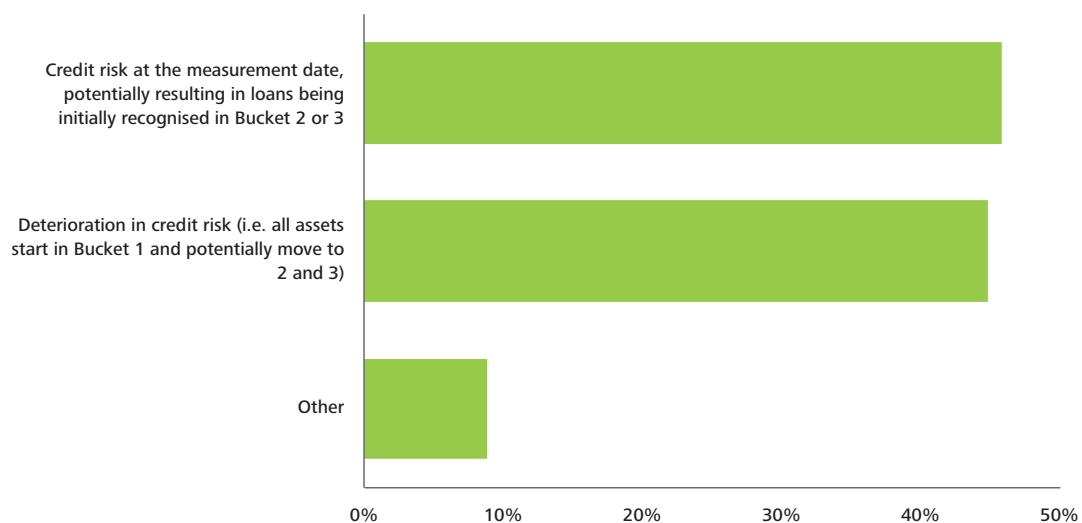


A majority of respondents thought that the European Union should wait for the finalisation of the macro fair value hedge accounting model before endorsing IFRS 9. In general, it seems that financial institutions want to adopt IFRS 9 as a whole rather than in stages.

IFRS 9 – Impairment accounting

The IASB and the FASB have spent considerable time debating whether the new model should be an absolute credit risk model or a relative credit risk model. The former would allocate loans into the three buckets based on the credit risk at the balance sheet date relative to what it was when the asset was initially recognised. The latter would categorise loans based on its absolute credit risk at the period end only and therefore would result in loans not necessarily starting in the first bucket.

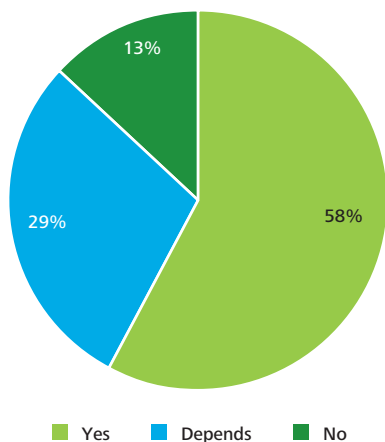
Figure 15. As an organisation, would you prefer that assets be included in the three buckets based on:



Responses were evenly split, indicating a broad equanimity as to the IASB’s decision with regard to the two approaches.

Responses were evenly split, indicating a broad equanimity as to the IASB’s decision with regard to the two approaches. The Boards’ have chosen to pursue a relative credit risk model but have decided to require certain purchased distressed loans to be recognised on initial recognition in Bucket 2 and 3. On the face of it this sounds like a contradiction to the relative credit risk approach but in practical terms it is not as the provision on purchased distressed assets would be based on the change in lifetime expected losses since the asset was acquired.

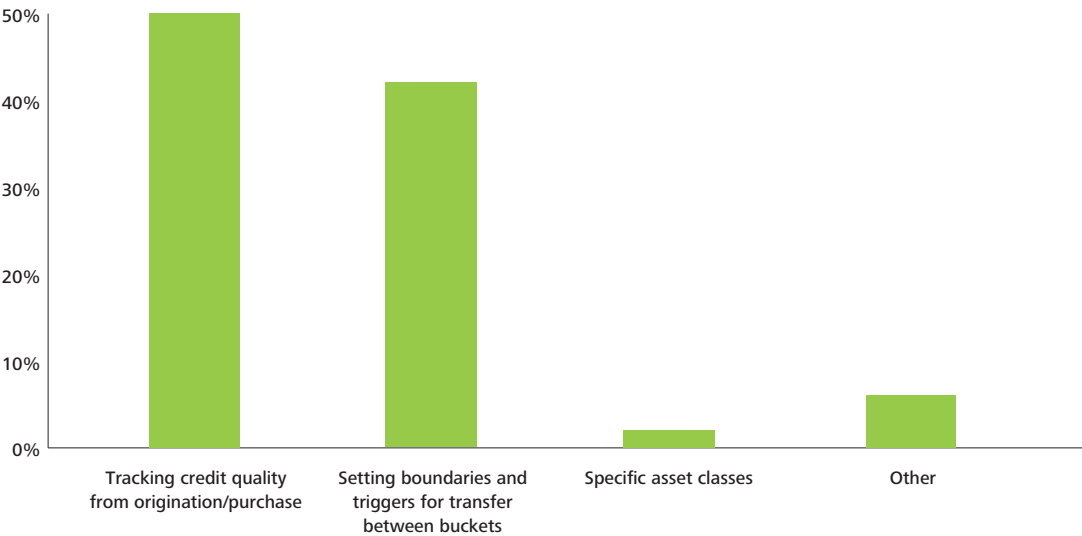
Figure 16. Ignoring the period over which credit losses are spread, do you believe stratifying loans into ‘three buckets’ as is currently being considered by the IASB and FASB (i.e. on the basis of deterioration in credit risk) is operational?



Despite mixed views on the model, the majority of respondents thought that the current model being considered by the IASB and the FASB is operational. However, this view may change depending on the extent to which the standard requires loans to be tracked as they move across the various buckets.

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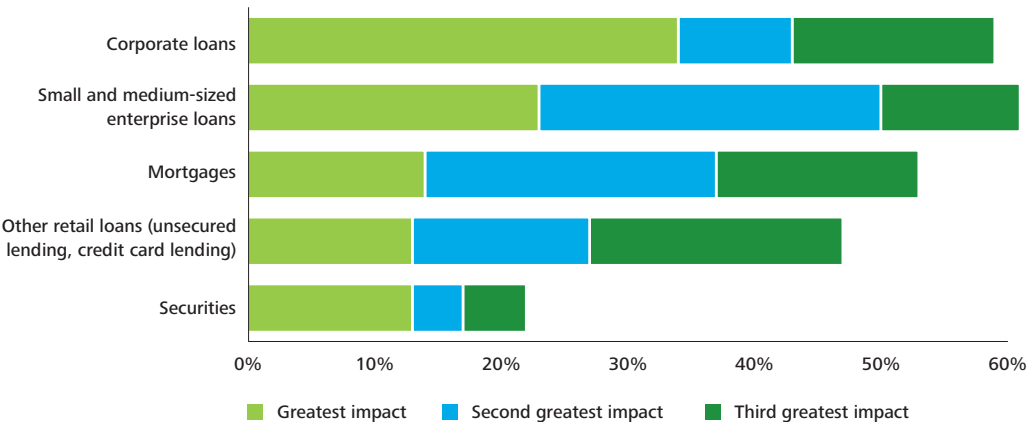
Figure 17. What will be the major implementation challenge if all assets are required to start in Bucket 1 and then transferred out of Bucket 1 on the basis of deterioration in credit risk?



The tracking of credit quality from origination or purchase is the biggest concern for participants. This is not surprising given that detailed loan tracking is likely to be complex and operationally difficult for financial institutions and would in itself be a major implementation challenge. A second major concern is the setting of boundaries and triggers for transfer between buckets.

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Figure 18. On which parts of your portfolio would the impairment rules as currently known result in the greatest degree of change in impairment provisions?



... respondents expect the impairment model that is currently being considered to have a significant impact on loans to corporates and loans to small and medium-sized enterprises.

Figure 18 illustrates that respondents expect the impairment model that is currently being considered to have a significant impact on loans to corporates and loans to SMEs. Whilst mortgages might make up a large part of the balance sheets of most participants, impairment provisions on mortgages is small in percentage terms when compared to impairment provisions on corporate lending.

Figure 19. Do you believe that bucket 1 should require 12 or 24 months of expected losses?

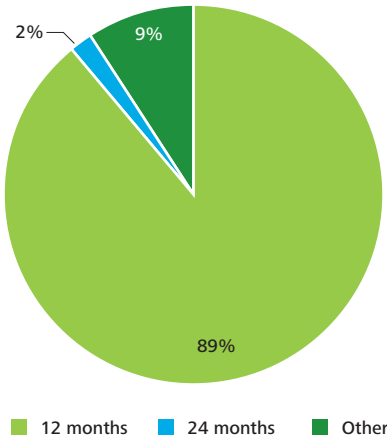
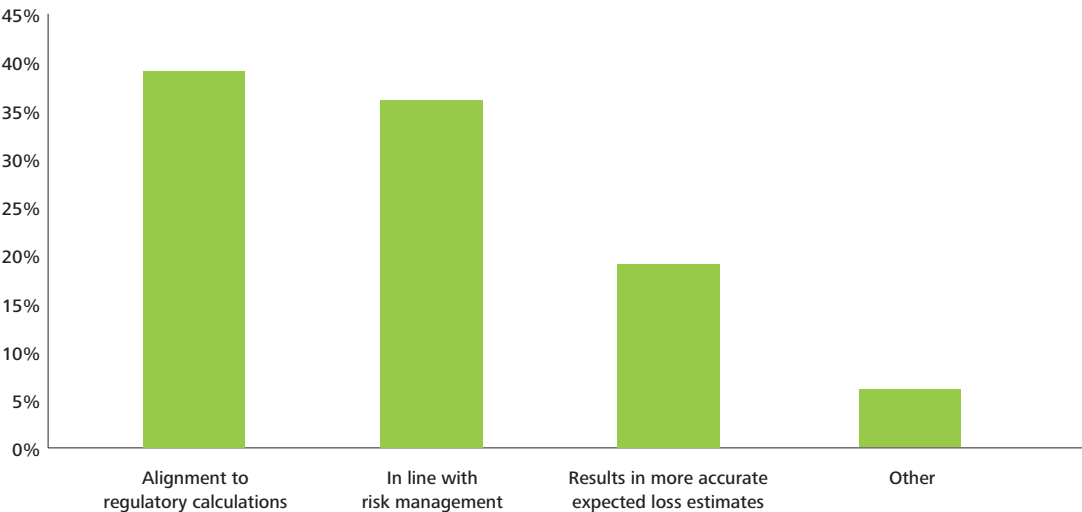


Figure 19(i). If 12 months, why?

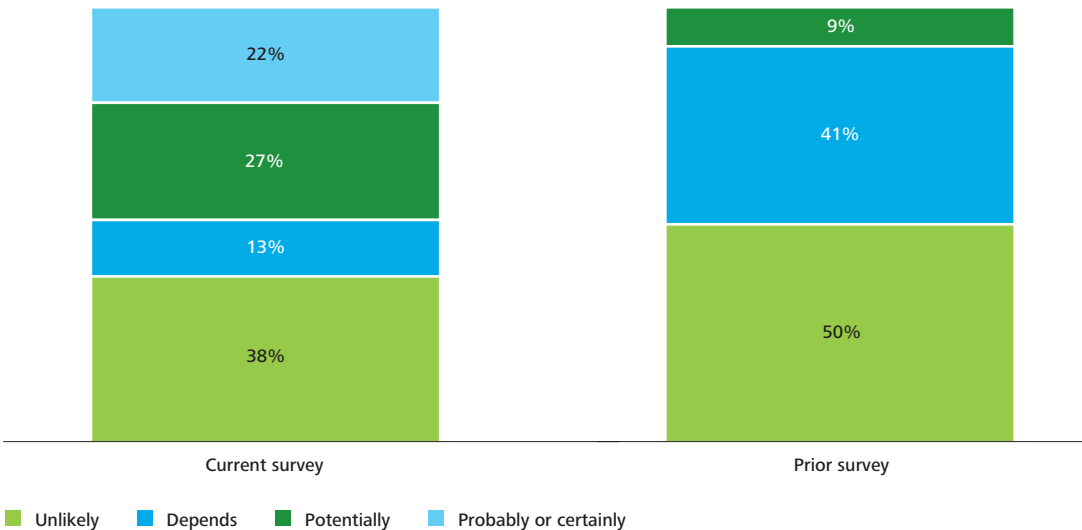


When asked whether Bucket 1 should require 12 months or 24 months of expected losses, 89% of respondents thought 12 months.

When asked whether Bucket 1 should require 12 months or 24 months of expected losses, 89% of respondents thought 12 months. This reflects the fact that emergence periods are often set at 12 months or less and is more closely aligned with regulatory Internal Ratings Based (IRB) calculations under Basel II, and thus more in line with banks’ risk management. A small minority of participants thought that Bucket 1 expected losses should be based on product type rather than a standard 12 months or 24 months across the board.

IFRS 9 – Product pricing and capital implications

Figure 20. Do you think that the expected loss impairment model will affect the pricing of products offered?

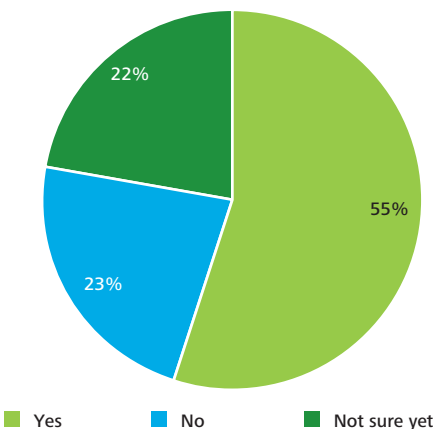


Participants had mixed views as to whether the pricing of products will be affected by the latest proposals for an expected loss impairment model. However, when compared to the results of the previous survey, there has been a significant increase in the number of participants who think that product pricing will probably or certainly be affected.

Some respondents thought that the impact on product pricing will be affected by how boundaries and triggers are set for transfer between Buckets 1 and 2. For example, if these are set such that most assets fall into Buckets 2 and 3, this will mean providing for lifetime expected losses and thus have a larger impact on banks' available capital. This in turn would likely be reflected in product pricing.

... when compared to the results of the previous survey, there has been a significant increase in the number of participants who think that product pricing will probably or certainly be affected.

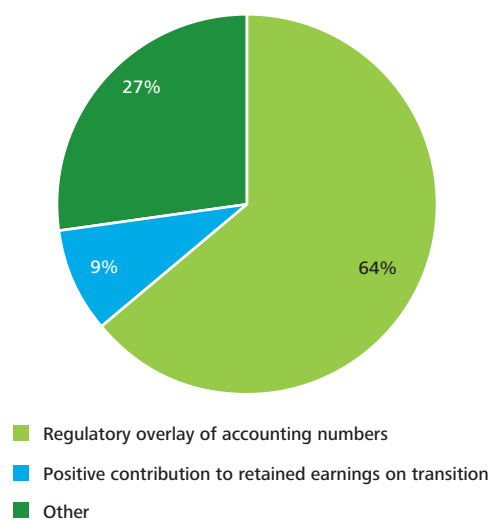
Figure 21. Based on what you know now about IFRS 9 and the Boards' deliberations do you expect IFRS 9 to increase capital requirements for the banking industry?



The majority of participants (55%) expect capital requirements to increase as a result of the introduction of IFRS 9.

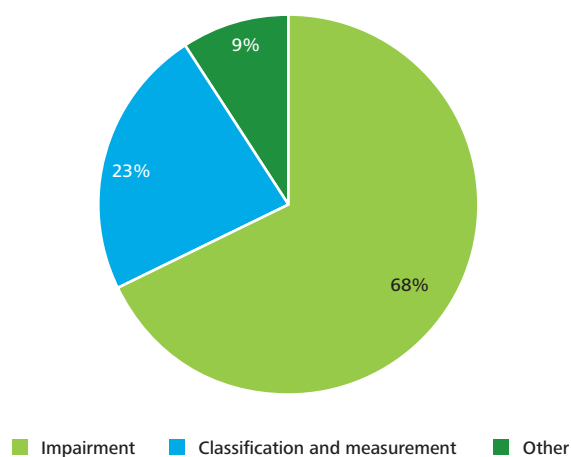
The majority of participants (55%) expect capital requirements to increase as a result of the introduction of IFRS 9. Despite this, the expected level of increase in capital requirements is not yet clear (see Figure 21(iii)).

Figure 21(i). If no, why?



Of the 23% who did not expect the IFRS 9 impairment charge to increase capital requirements, most were driven by an expectation that regulatory capital would not be entirely based on accounting results. A few expected to have a capital benefit from the transition to IFRS 9 (driven by the classification and measurement rules).

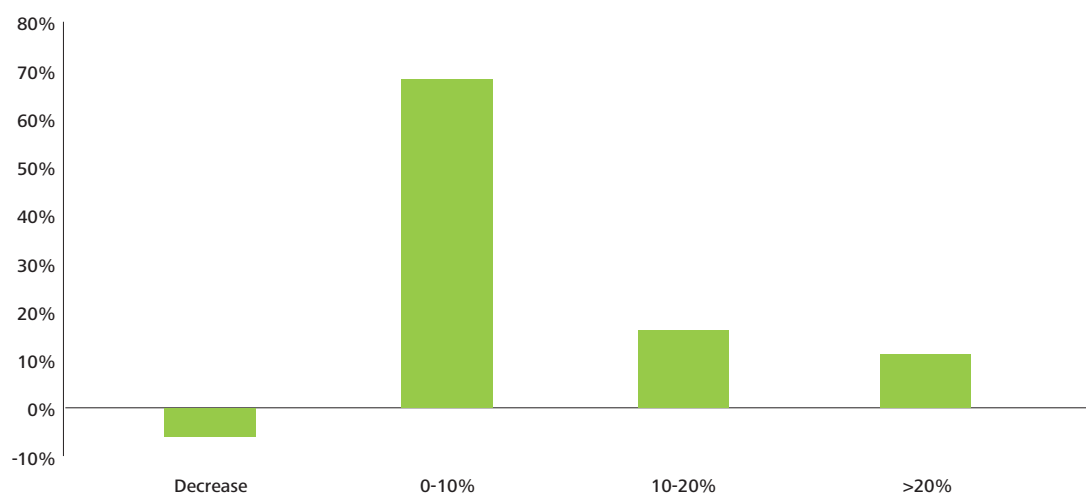
Figure 21(ii). If yes, why?



Of the 55% expecting an increase, two thirds were particularly focused on impairment.

Figure 21(iii). For Board strategic planning purposes, what is your best estimate of the change in capital requirements for your organisation resulting solely from IFRS 9?

This bar chart depicts the results for the 36% of respondents who provided an estimate

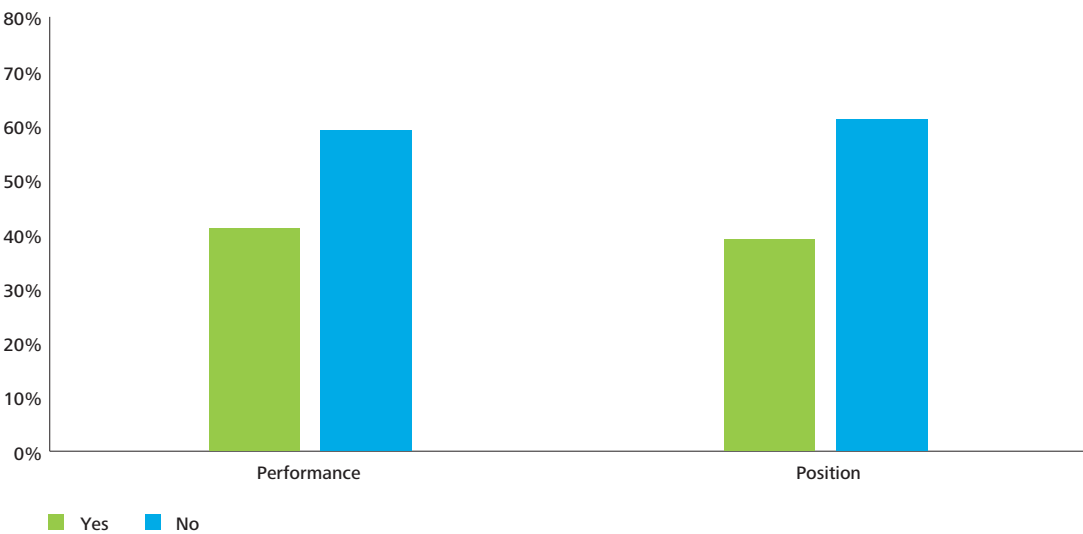


Of the 36% proffering a view of the capital impact of IFRS 9, two thirds expected an increase in capital requirements of up to 10%.

When asked to quantify the change in capital requirements resulting from transition to IFRS 9, most respondents (64%) were unsure. Of the 36% proffering a view of the capital impact of IFRS 9, two thirds expected an increase in capital requirements of up to 10%.

IFRS 9 – Impact on financial statements

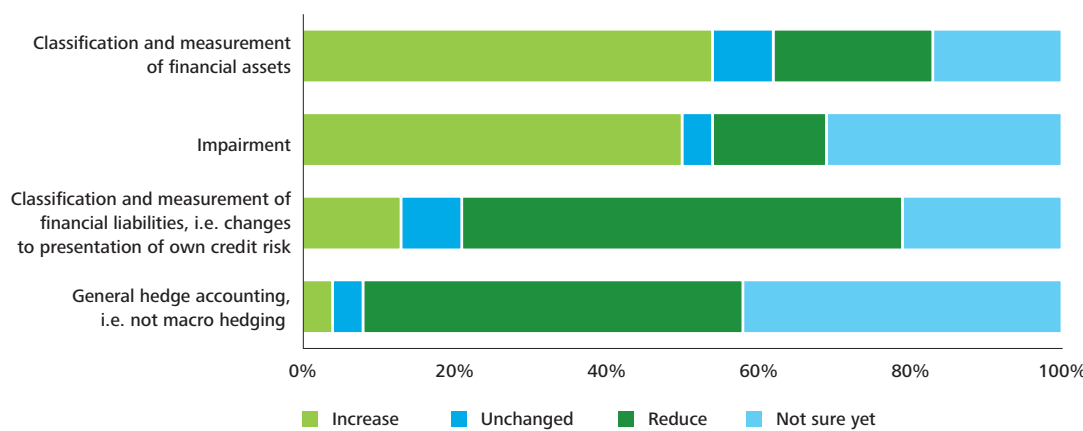
Figure 22. Based on what you know now about IFRS 9 and the Boards’ deliberations, do you expect IFRS 9 to more accurately reflect the financial performance or financial position of your firm?



... the majority of participants stating that IFRS 9 would not more accurately reflect the financial performance or financial position of financial institutions, a key overall objective of the IAS 39 replacement project.

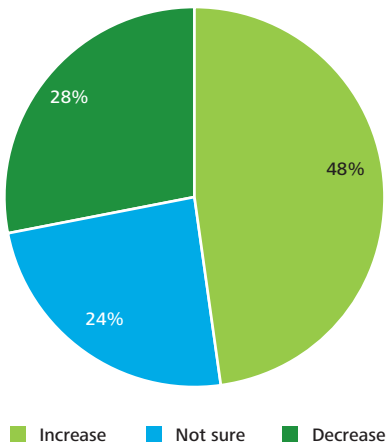
As previously noted in figure 6, many respondents were not convinced that IFRS 9 would increase the usefulness of financial statements. This view is reiterated here with the majority of participants stating that IFRS 9 would not more accurately reflect the financial performance or financial position of financial institutions, a key overall objective of the IAS 39 replacement project.

Figure 23. Based on what you know now about IFRS 9 and the Boards’ deliberations do you expect the following aspects to reduce or increase the volatility of reported earnings?



Most respondents thought that the rules for classification and measurement of financial assets and the proposed rules for impairment would result in increased volatility of reported earnings. In contrast, most respondents expect the changes to classification and measurement of financial liabilities (i.e. the changes to presentation of own credit risk) and the proposed hedge accounting rules to reduce volatility. However, as expected, there is a higher degree of uncertainty around the impact of aspects of the standard which have yet to be finalised (i.e. impairment and hedge accounting).

Figure 24. Overall, based on what you know now about IFRS 9 and the Boards’ deliberations, do you expect IFRS 9 to reduce or increase the volatility of reported earnings?

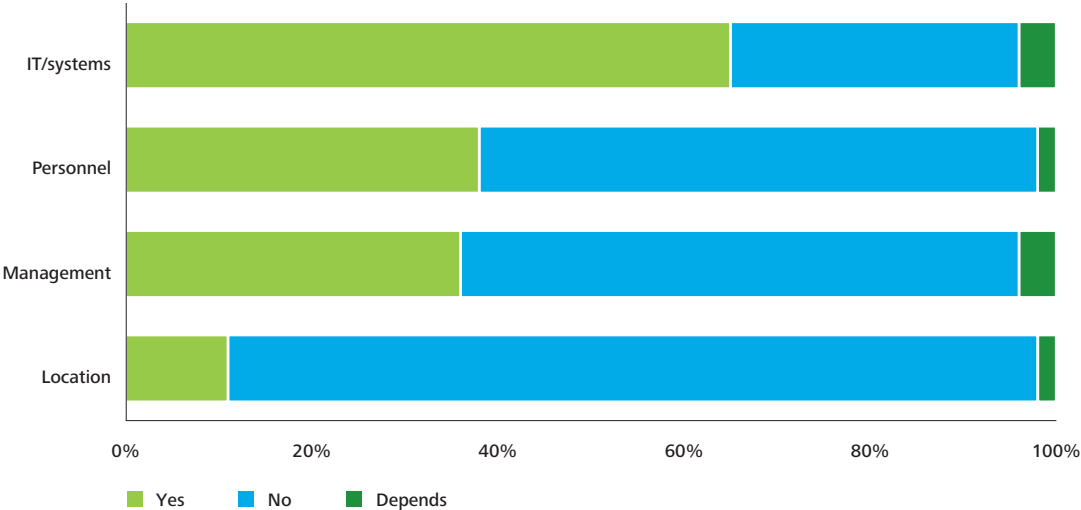


On the whole, respondents expect the implementation of IFRS 9 to result in increased volatility of reported earnings.

IFRS 9 – Implementation

... the general view is that the implementation of IFRS 9's impairment accounting rules in particular will require a high level of integration between banks' finance and credit risk departments.

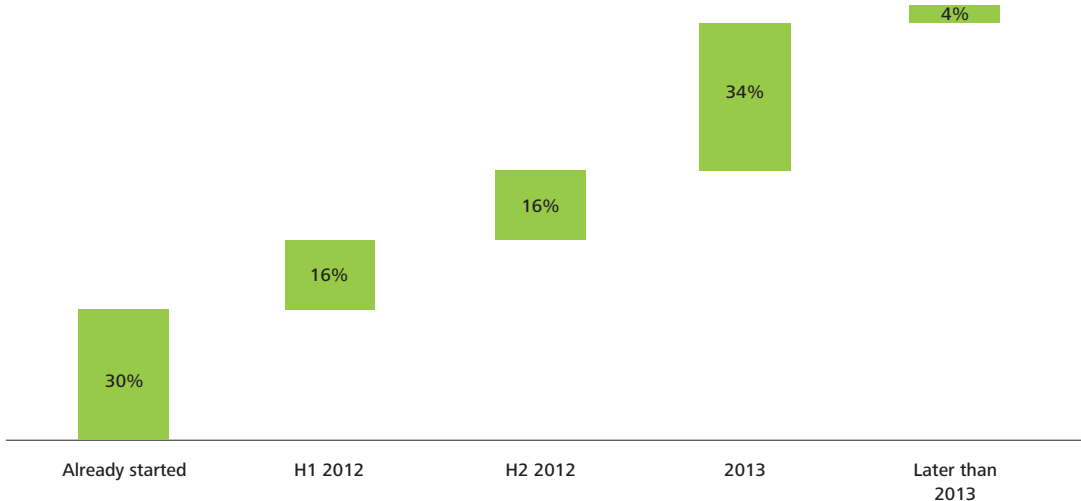
Figure 25. Many commentators point to there being a need for a greater link between risk and finance as a result of IFRS 9. Do you believe that IFRS 9 will trigger integration of credit risk and finance departments in the following aspects?



Whilst IFRS 9 is expected to provide a more simplified approach to financial instruments accounting in many ways when compared to IAS 39, the general view is that the implementation of IFRS 9's impairment accounting rules in particular will require a high level of integration between banks' finance and credit risk departments. 65% of respondents expect further integration of finance and risk systems.

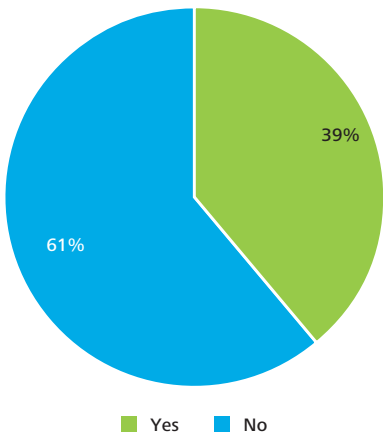
Most participants have already started planning for the transition to IFRS 9 with 62% expecting to have started by the end of the 2012.

Figure 26(i). When do you expect to start your IFRS 9 implementation project?



Most participants have already started planning for the transition to IFRS 9 with 62% expecting to have started by the end of the 2012. This underpins the fact that most respondents have indicated some level of involvement at a higher level in their organisations as previously shown in figure 3.

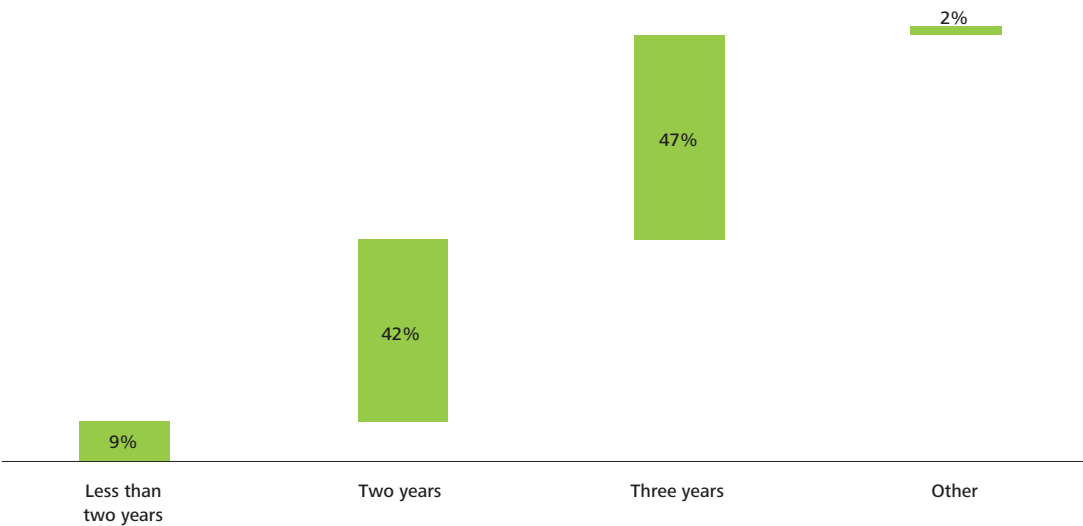
Figure 26(ii). Will the delay in the EU endorsement process for IFRS 9 result in the postponement of a significant portion of your IFRS 9 implementation project?



... despite the numerous other demands from business and regulatory change, almost two thirds of participants did not expect the uncertainty surrounding final EU endorsement to delay their IFRS 9 implementation project.

For respondents based in the EU, the questions surrounding the timing of EU endorsement is a major factor with some expecting a postponement of a significant portion of their IFRS 9 implementation project until IFRS 9 is finalised and endorsed by the EU. However, despite the numerous other demands from business and regulatory change, almost two thirds of participants did not expect the uncertainty surrounding final EU endorsement to delay their IFRS 9 implementation project.

Figure 26(iii). Assuming IFRS 9 is finalised in 2012, what timeframe do you believe is necessary for your institution to complete implementation?



89% of respondents thought that two years or more will be required to complete implementation reflecting the complexity and operational challenges of the standard.

89% of respondents thought that two years or more will be required to complete implementation reflecting the complexity and operational challenges of the standard.

Figure 27. What work do you intend to start before the standards are finalised?

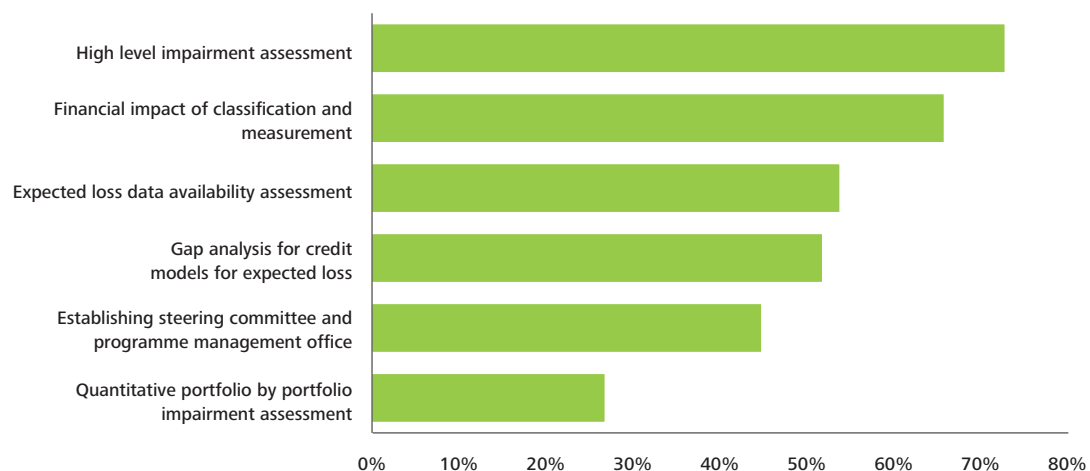
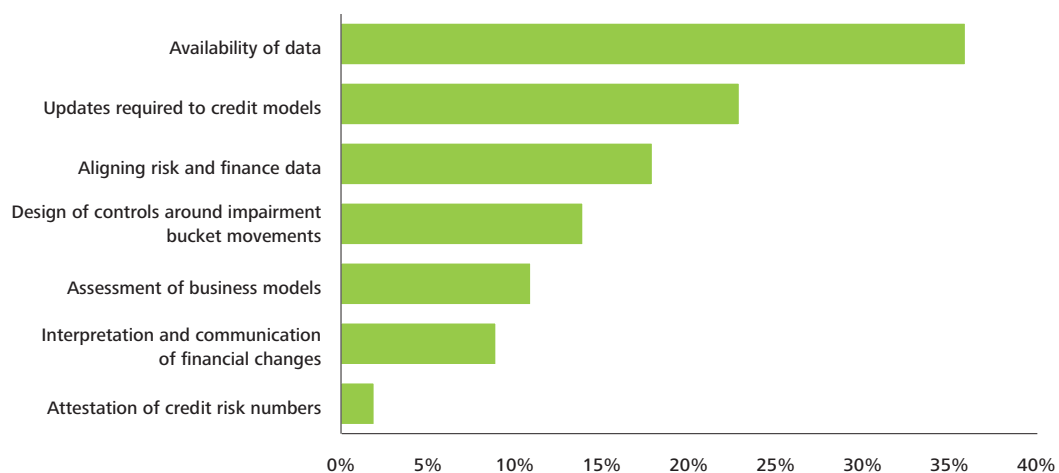


Figure 27 depicts the various activities being performed by participants in the build-up to the final standard, building on figure 26(i) above. Based on participants' responses, most banks are already at least in the planning phase of IFRS 9 implementation.

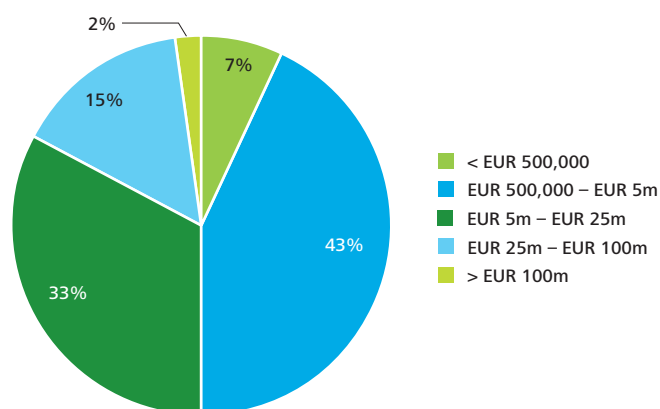
36% of respondents identified the availability of data as being the biggest challenge for implementing IFRS 9.

Figure 28. What do you think will be the biggest challenge in terms of implementing IFRS 9?



36% of respondents identified the availability of data as being the biggest challenge for implementing IFRS 9. Historical data will be critical for building and updating accurate credit models and in some instances, the data required will not be readily available. Furthermore, once the models are built, the expectation is that monitoring changing credit quality and impairment levels for individual credit exposures will be a data intensive exercise requiring enhancements to existing systems and processes.

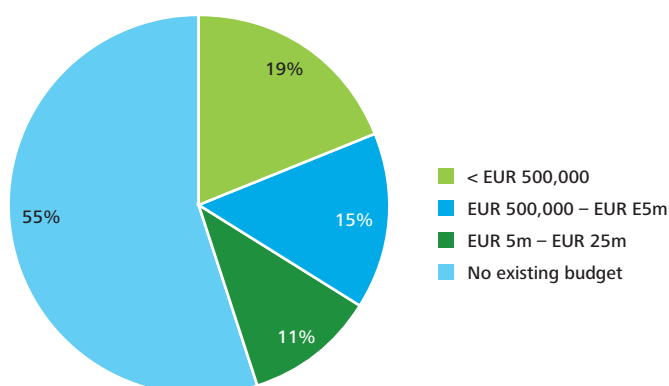
Figure 29(i). What do you estimate the total budget that you may require to meet IFRS 9 requirements?



More participants now have budgets committed to IFRS 9 implementation than in the previous survey. A simple weighting of budgets show an 18% increase from €14.9m to €17.5m per bank since the previous survey.

More participants now have budgets committed to IFRS 9 implementation than in the previous survey.

Figure 29(ii). Do you have any existing 2012 budget currently being spent or committed to IFRS 9?



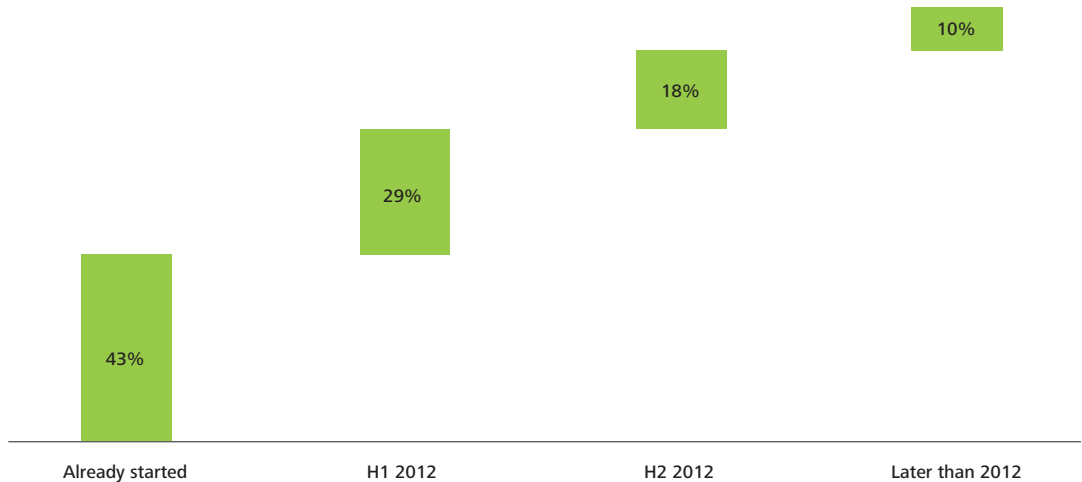
However, considering that 62% expect to start their IFRS 9 implementation project by the end of the current year, it is surprising that 55% still do not have a budget committed for 2012. On the same weightings as before, those who have an existing budget have €4.8m set aside, less than a third of the estimated final cost.

... considering that 62% expect to start their IFRS 9 implementation project by the end of the current year, it is surprising that 55% still do not have a budget committed for 2012.

IFRSs 10, 12 and 13

The impact of IFRS 10 *Consolidated Financial Statements* and IFRS 12 *Disclosure of Interests in Other Entities* should not be underestimated. The banking industry as a whole is highly exposed to the scope of consolidation in their financial reporting and have significant involvement with structured entities. Banks constantly manage the size of their balance sheets, so the impact of a new consolidation standard could have dramatic implications, for instance on capital requirements and balance sheet optimisation. Additionally, key performance indicators such as net interest margin and leverage ratios will be directly affected by the consolidation or deconsolidation of entities with which banks are involved.

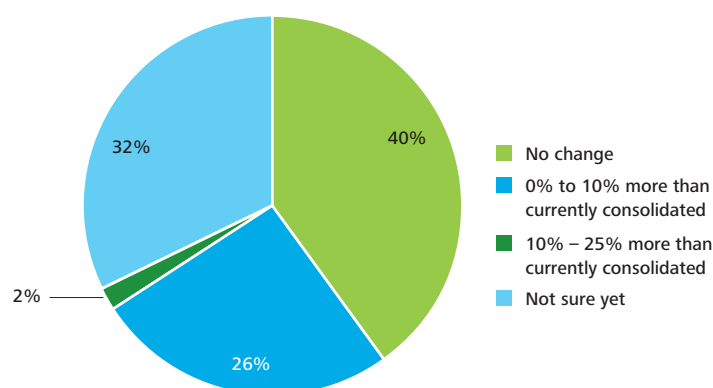
Figure 30. When do you expect to start your project to implement IFRS 10 and IFRS 12?



Given the 1 January 2013 mandatory effective date, it is surprising that 29% of respondents are just starting their project to implement IFRS 10 and IFRS 12 and 28% of respondents have not yet started.

Furthermore, regardless of the impact of IFRS 10 and IFRS 12 on banks' balances sheets and disclosures, the consolidation assessments and the effort required to identify and disclose information on structured entities is a significant exercise to undertake. Considering the 1 January 2013 mandatory effective date, it is surprising that 29% of respondents are just starting their project to implement IFRS 10 and IFRS 12 and 28% of respondents have not yet started, particularly given the requirements to report comparative information.

Figure 31(i). To what extent do you expect the total number of interests in entities consolidated to change as a result of the introduction of IFRS 10?

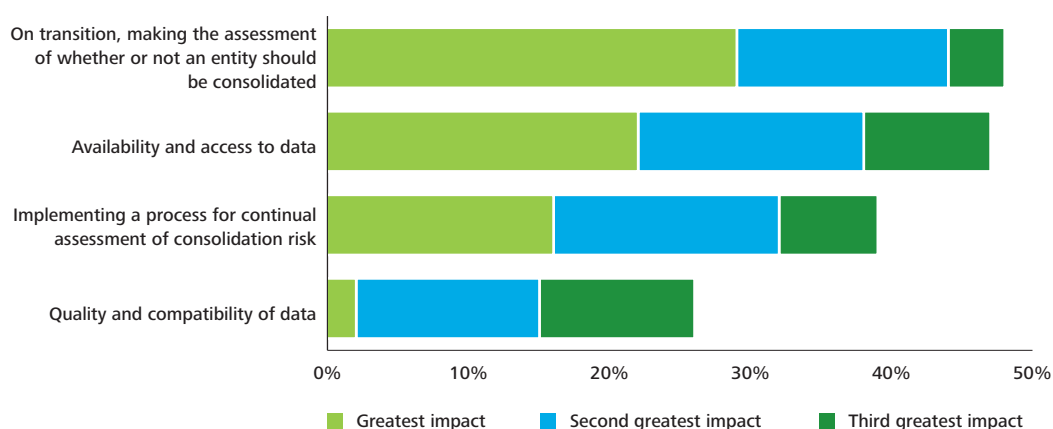


In terms of the impact of IFRS 10 on the number of entities consolidated, whilst 40% of respondents expected no change, a quarter expected an increase of up to 10%.

In terms of the impact of IFRS 10 on the number of entities consolidated, whilst 40% of respondents expected no change, a quarter expected an increase of up to 10%. Nearly a third have not yet ascertained the impact.

One of the potential obstacles for banks successfully implementing IFRSs 10 and 12 may be the level of transparency and access to financial records of previously unconsolidated Special Purpose Entities (SPEs). Furthermore, banks need to consider the capital implications of adopting IFRS 10, especially in an evolving regulatory landscape where banks are focusing on newly imposed leverage ratios and making strategic decisions about divesting business lines which are not achieving sufficient levels of return on equity.

Figure 31(ii). What do you think will be the biggest challenge in terms of implementing IFRS 10?

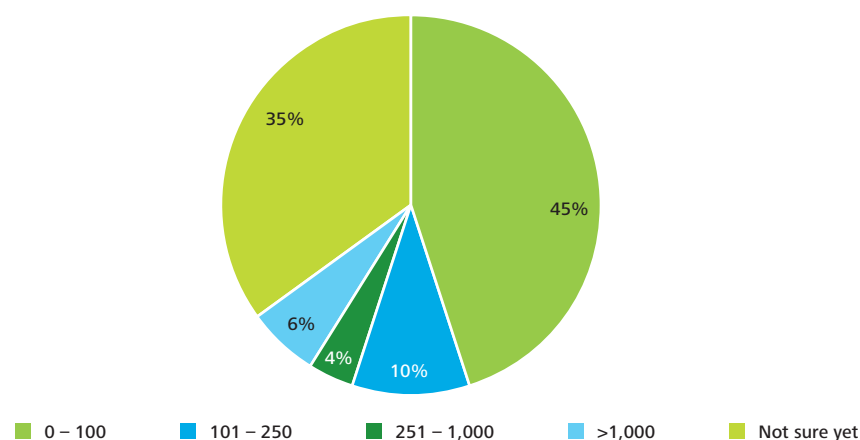


In terms of implementing IFRS 10, the biggest challenge for respondents appears to be the assessment as to whether or not an entity should be consolidated. Other concerns were the availability and access to data and the implementation of a process for continual assessment of consolidation risk.

Early assessment of the implications of the new consolidation rules may allow financial institutions to revise contracts, partnership and management agreements as well as investments to avoid undesirable consequences once the standard becomes effective. An early assessment will also allow time for the development of interfaces with systems of third parties that hold the required data, where application of the new rules results in a significant increase in the number of consolidated entities.

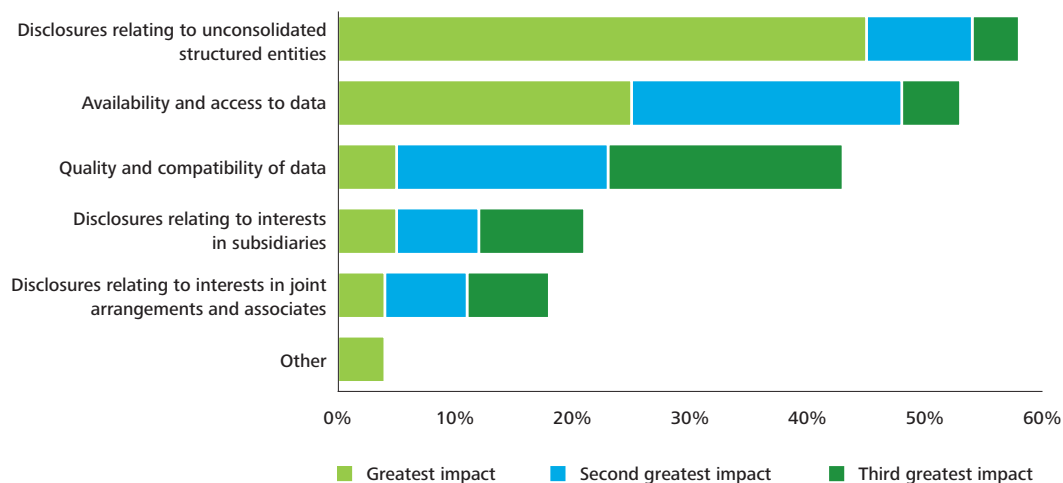
A large proportion of respondents indicated that they are not yet sure about the scope of IFRS 12. This may explain why a large segment of participants have not yet started their transition projects.

Figure 32(i). How many “interests in unconsolidated structured entities” do you expect to be in the scope of IFRS 12?



A large proportion of respondents indicated that they are not yet sure about the scope of IFRS 12. This may explain why a large segment of participants have not yet started their transition projects. Excluding those who are not yet sure, this broadly indicates an expectation of 192 unconsolidated structured entities per bank.

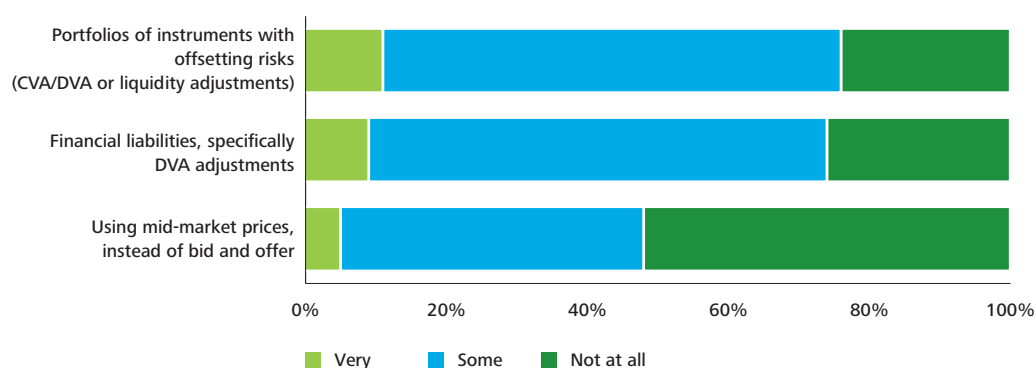
Figure 32(ii). What do you think will be the biggest challenge in terms of implementing IFRS 10?



The implementation challenges for IFRS 12 are similar to those which organisations face in implementing IFRS 10. The majority of respondents felt that the new requirement for disclosure of unconsolidated structured entities would require the most effort.

The majority of respondents felt that the new requirement for disclosure of unconsolidated structured entities would require the most effort.

Figure 33. To what extent will the introduction of IFRS 13 *Fair value measurement* change the way you determine fair value when fair valuing?



IFRS 13 has not brought about wholesale change in fair valuation when compared to IAS 39, though most respondents expect some impact in the way they calculate portfolio adjustments for credit risk and liquidity risk.

Planning for change with Deloitte

Accounting change, in particular IFRS 9, is expected to have a significant impact on accounting policies, IT and processes, some requiring adjustments to valuation models, booking engines and reporting. The link between business model and classification will bring the market areas into the discussion. The changes to impairment will take us to an expected loss impairment model away from the incurred loss only model under IAS 39, and it is anticipated that the expected loss model will require a much closer alignment between Risk and Finance functions across banks resulting in increased data requirements and better external reporting of loan loss assumptions and projections to stakeholders.

Deloitte has been working with a number of major institutions in assessing the financial, business and operational implications of draft and final accounting standards. For all financial institutions there will be considerable interaction between accounting change and regulatory capital requirements. Banks with a more advanced credit risk management framework (e.g. Basel II and later, Basel III) will have an opportunity to leverage synergies. For these organisations, the focus during the IFRS 9 transition is to identify, evaluate and utilise overlaps between risk management and accounting frameworks. Other institutions may find accounting change forces them to enhance credit management systems and processes considerably. In addition, IFRS 10 and 12 will require considerable effort to identify and disclose information on structured entities.

Deloitte is uniquely positioned to work with clients from the initial assessment phase through to achieving regulatory compliance, leveraging member firms' deep accounting and advisory, data analytics and management, risk, technology and change consulting skills to deliver integrated cross-functional projects.

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Issues/Implementation challenges	How Deloitte can help
Initial understanding of accounting changes and expected developments	<p>Provide regular briefings to senior management across the firm.</p> <p>Share industry insights and provide initial views on draft and final standards.</p>
Perform a preliminary assessment of the impact of accounting change both within finance and across the wider business.	<p>Perform a high level assessment of the financial and operational impact of accounting change.</p> <p>Perform a detailed readiness review, covering:</p> <ul style="list-style-type: none"> • Finance processes and reporting • Risk modelling • Data & technology • Organisational design and governance. <p>Perform simulations of the impact of the new rules on financial statements.</p> <p>Assist in the assessment of the impact of the new rules on key performance indicators and other key metrics.</p> <p>Prepare a high-level implementation plan and indicative cost estimates.</p>
Benchmarking the organisations' change management agenda against peers and other industry participants	<p>Provide observations of how others are approaching their accounting change implementation project and how they are dealing with challenges that arise.</p>
Plan, design and build	<p>Assist management in the design of the target operating model for their accounting change implementation project.</p> <p>Assist management with the identification/sourcing of data required.</p> <p>Advise and assist with the modification of current systems/models and the development of bespoke systems/models where necessary.</p> <p>Support management in the design of ongoing governance processes and post-implementation controls.</p>
Implementation and testing	<p>Contribution of cross-functional skills and resources to support the implementation effort including subject matter experts.</p> <p>Provide project governance and management services where required.</p> <p>Assist with documentation of policies and procedures.</p> <p>Provide assurance on the implementation effort through testing and other substantive procedures.</p> <p>Assist with the development of a communication plan to key stakeholders.</p>
Post implementation reviews and ongoing support	<p>Ongoing support to improve level of automation and to generate efficiencies.</p> <p>Continuous monitoring of effectiveness and remediation of issues which arise.</p> <p>Ongoing provision of briefings on technical matters and insights into developing industry practice.</p>

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