Third Global IFRS Banking Survey
Still far from land?

Contents

Preface

Welcome to the *Third Global IFRS Banking Survey*. It is the culmination of several months' work by Deloitte.* The Deloitte global financial services industry practices have gathered the latest thinking from 70 major banks, in order to inform your thinking about the technical and practical matters associated with implementing accounting change.

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Previous Deloitte Global IFRS Banking surveys have stimulated discussion with a range of key stakeholders. We hope this survey will once again provide you with insights into the current thinking across the industry and help develop market consensus by supporting conversations amongst institutions, investors, regulators and standard setters.

We are extremely grateful to all the institutions and individuals who have participated in this survey, and thank you warmly for your contribution. We hope you find the report valuable, and look forward to discussing our findings with you.

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Executive summary

Banks' financial reporting, particularly in relation to financial instruments, continues to be the subject of intense scrutiny by investors, regulators and the financial press. It is also a matter of heated debate: for practical and intellectual reasons, stakeholders have different and sometimes opposing views on what a good accounting treatment should look like.

This report captures banks' current views on the International Accounting Standards Board's (IASB) new standards and proposed changes. To achieve this, Deloitte surveyed 70 banks from across the world, including 19 Global Systemically Important Financial Institutions (G-SIFIs). The survey asked questions about the interaction between the IASB and Financial Accounting Standards Board's (FASB) proposals, and how probable convergence between them is. The survey also asked how banks would like to see IFRS 9 develop with respect to impairment, classification and measurement, and hedge accounting and what impact the new standards on fair value measurement will have.

The survey found most banks in the sample consider the IASB and FASB are no longer on track to converge, despite the fact that previous survey results found significant support amongst banks for the convergence process. The two standard-setting bodies now appear to favour different expected loss models for impairment.

Responses from the banks (principally IFRS filers), suggests the IASB's likely impairment model is generally preferred by the industry. Yet despite significant support for the proposals, which banks think will increase their level of impairment provision, banks are putting their implementation efforts on standby as the process of completing changes to financial instruments accounting is subject to delay. There is growing uncertainty about the outcome of financial instruments accounting change: compared to previous survey results, more banks consider that the new requirements cannot be implemented in a way that will increase comparability between banks.

The accounting for banks' liquidity portfolios continues to be an issue in the light of the recent proposed amendments to classification and measurement. As with impairment, these proposed reforms highlight the pressure the IASB may come under, not least because the accounting numbers are often also used for regulatory purposes. Consensus is building that the capital and pricing impacts of accounting changes around impairment, debit valuation adjustments (DVAs) and liquidity portfolios will be significant.

A majority want to see changes in macro hedge accounting, but a third do not and of these a third want to retain the European Union (EU) carve out. This lack of consensus suggests the IASB will continue to face opposition when it further develops changes to macro hedge accounting.

Introduction

The unprecedented and sustained high level of interest in banks' financial statements continues unabated, not least due to their key role in supporting economic activity. There are simultaneous demands for banks to increase their capital bases and lend more; the quality of collateral they hold is at the same time coming under scrutiny. Added to this, recession in parts of the world, continuing low interest rates and significant regulatory change mean banks are competing in a difficult environment.

These are certainly interesting times, as the IASB's work since the financial crisis has been particularly relevant to banks. As the IASB works hard to develop consensus in financial instruments accounting, including finding common ground with the US standard setter, the IASB has been the subject of much attention from politicians and press. As impairment accounting features high on the agenda of national regulators, including for example the Financial Policy Committee in the UK, this high level of attention looks set to continue.

Although of significant interest for banks, the requirements the IASB develops have to be suitable for all types of businesses. That said, banks' financial statements will be affected to a greater extent by the financial instruments proposals than will many other businesses. The financial services industry is watching the IASB's and the Financial Accounting Standards Board's pronouncements very closely.

Deloitte wanted to find out what banks think about the IASB's recent activities and planned direction of travel, in order to enrich conversations between banks, standard setters, regulators, accountants and auditors. This year's report is based on responses to 29 technical and practical questions on the following topics:

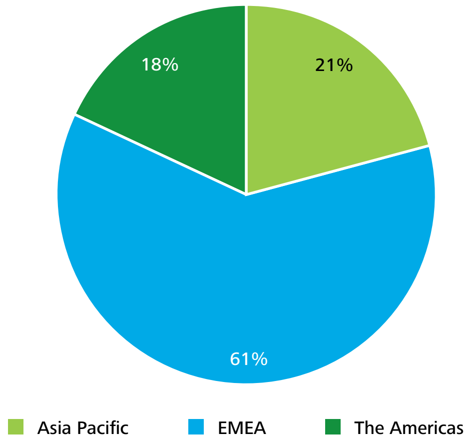
- awareness and high-level impact of accounting change;
- IFRS 9 **Financial Instruments** including convergence, classification and measurement, impairment and hedge accounting;
- IFRSs 10 **Consolidated Financial Statements** and 12 **Disclosure of Interests in Other Entities**;
- IFRS 13 **Fair Value Measurement**, specifically debit valuation adjustments; and
- offsetting.

This is the third time Deloitte have surveyed the world's major banks on these topics. Previous questionnaires were sent to participants in the first and last quarters of 2011, and findings were published in IFRS 9 **Impairment Survey** 2011 and **Second Global IFRS Banking Survey** – Q1 2012 respectively. This survey's growing dataset from these means the survey is able to examine how views towards accounting standards are changing over time. In the analysis that follows this year's survey highlights the most interesting trends. In the charts in this report, the 2011 survey is referred to as the 1st, the quarter one 2012 survey as the 2nd, and the current survey as the 3rd.

Reach of survey

Once again, this survey has achieved a global reach, which takes into account views from 70 banks from Europe, the Middle East & Africa, Asia Pacific and the Americas. Responses were received from 19 of the 28 global systemically important financial institutions (G-SIFIs) determined by the Financial Stability Board, including 14 of the 16 IFRS reporters. In total, 24 of the top 50 global banking groups measured by total assets listed in the Banker Top 1000 World Banks 2012 took part. In most instances, responses have been co-ordinated from the accounting policy or finance area although many respondents have sought the views of other key areas of the bank such as the credit risk department. This year there are an increased number of respondents, as 70 took part compared with 56 in each of the previous two surveys.

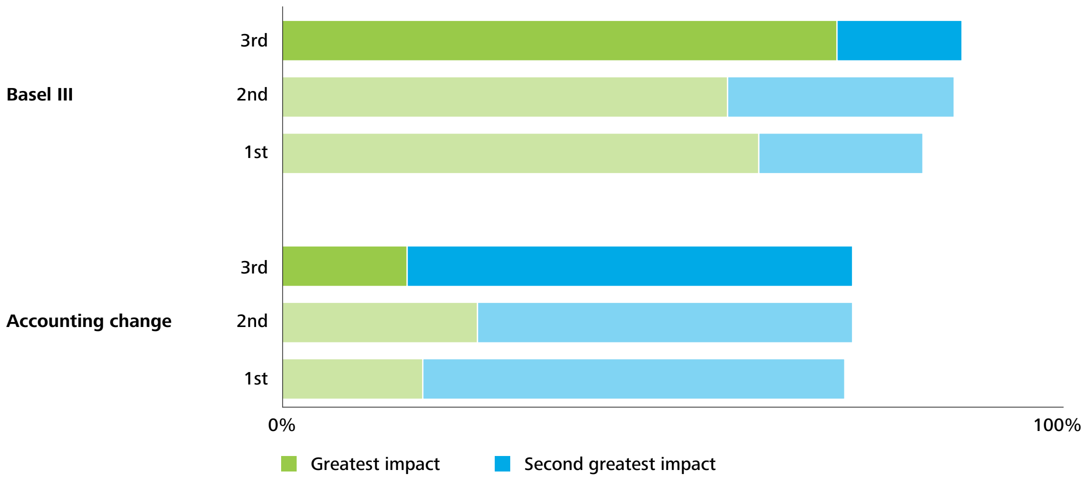
Figure 1. Geographical spread of respondents



The majority of respondents were banks based in Europe, including many of the major institutions in France, Germany, Italy and the UK. Banks from South Africa are included in the EMEA region of the above pie chart. Respondents from the Americas included IFRS reporters in Brazil and Canada and US banks reporting under US GAAP. From the Asia-Pacific region, contributors included banks from Japan, China, South Korea and Australia. The geographical diversity of the participants means the responses explored below reflect the practices and expectations of a diverse range of global banks.

Awareness and high level impact

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



In all three surveys, regulatory change driven by the Basel Committee on Banking Supervision has consistently been expected to have a greater impact on banks than accounting or other regulatory change. This year's survey shows that regulatory change has grown in significance since the last survey asked about it. Although still unclear in places, the IASB's direction on key issues has become more definite during the course of 2012, and this is likely to explain the slight decrease since the previous survey in the proportion regarding accounting change as having the greatest impact. Managing Basel III regulations and implementation timelines across jurisdictions is a significant project for multi-national banks, not least as the requirements for head office and in local countries are not identical. Some banks told us they are working on developing internal ratings-based models, which is complicated and resource- intensive work. Banks are also undertaking other projects initiated by local regulators to implement Basel III. As with IFRS, changing timelines and different degrees of commitment to implementation by national regulators means Basel III change is also an uncertain process.

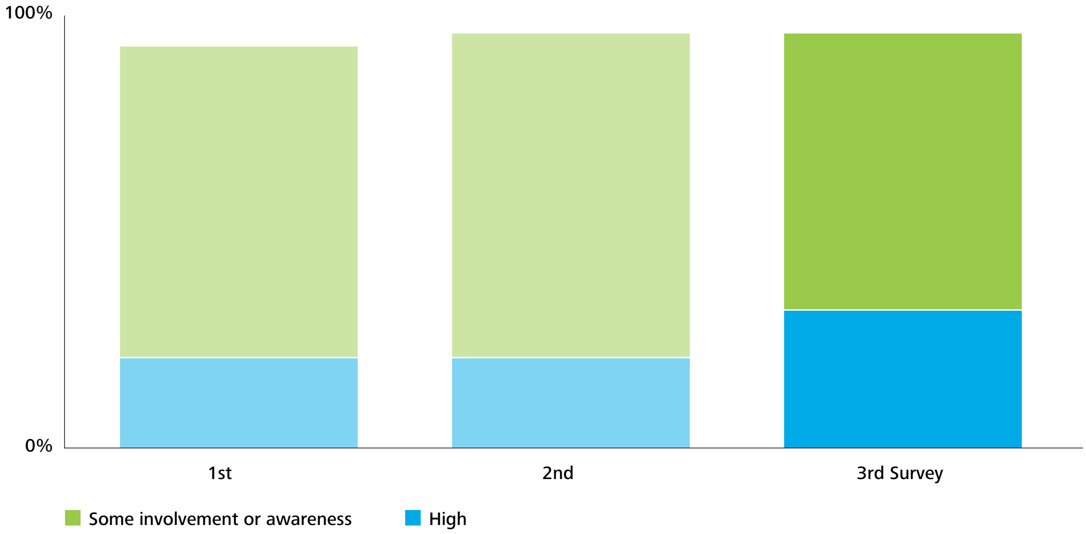
Other regulatory changes

In addition to the liquidity, capital disclosure and other changes driven by Basel, banks are affected by many other regulatory changes. The US Foreign Account Tax Compliance Act (FATCA) will affect banks across the world when it takes effect in 2013, as it requires banks to provide information on their American account holders. Some banks are thought to have closed brokerage accounts in order to avoid having to collate the information that would otherwise be required. FATCA was highlighted by respondents in Europe and North America as a significant source of change. In the US the Dodd-Frank Wall Street Reform and Consumer Protection Act is bringing in widespread change for banks, including the Volcker rule. In Europe banks are responding to changes in the Markets in Financial Instruments Directive (MiFID), the new European Market Infrastructure Regulation (EMIR), the European Banking Authority's revised common regulatory and financial reporting frameworks (COREP and FINREP) as well as proposals for recovery and resolution planning (RRP). There is in addition an increased focus on banks' management of client monies and assets. In the longer term the introduction of the Single Supervisory Mechanism is also expected to affect banks active in Europe. The Financial Stability Board's work on disclosures, undertaken by the Enhanced Disclosure Task Force, was one of the topics highlighted by banks in Asia.

Capital requirements, which may be based on accounting information, are increasing in many countries, which will drive up the cost to banks of providing certain products.

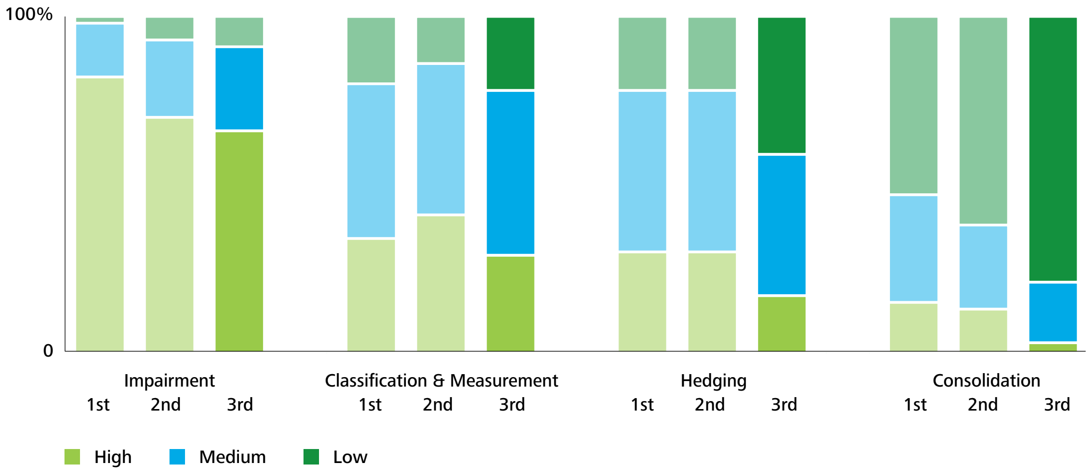
As this indicates, the number of regulatory initiatives is high: given the delays associated with planned changes to accounting standards it is unsurprising that these likely accounting changes are, until finalised and looming, seen to be of secondary significance. That said, many of the regulatory changes are closely tied to banks' financial reporting. For example, in Europe, EMIR will lead to an increased use of central counterparties by banks trading in derivatives, affecting their credit risk exposure and disclosure. Capital requirements, which may be based on accounting information, are increasing in many countries, which will drive up the cost to banks of providing certain products.

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



The majority of banks continue to report a moderate but increasing level of awareness and involvement in accounting change at board and audit committee level, despite the deferred deadlines. In particular, the significant growth in those respondents indicate that board and audit committee involvement and awareness is now 'high'. This is a natural development as rules become clear and banks begin to move towards implementation. For some banks, involvement at the audit committee level is much more significant than at full board level. Provisions for impairment and the link between accounting and regulatory capital are likely to be behind boards' increased awareness.

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 surveys, impairment is still expected to be the accounting change with the greatest impact. Yet over the period of the three surveys there has been a reduction in those that consider impairment as high impact. This shift in sentiment may reflect the move away from the original proposals presented by the IASB which were regarded as operationally more challenging to the more recent proposals that are intended to rely more on existing credit risk management and regulatory information. The impact of classification and measurement has decreased, as have hedging and consolidation. The reduced perceived impact of all the proposed accounting changes may also reflect growing familiarity with the likely extent of the proposed changes.

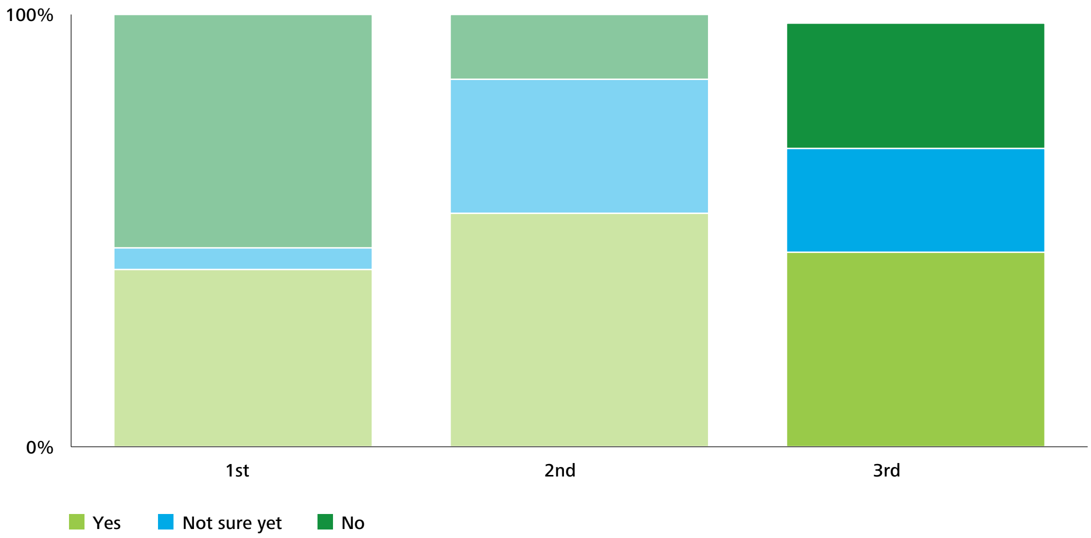
Where banks identified other accounting changes that would affect their financial statements, lease accounting was the most frequently mentioned, being highlighted by banks in the Asia Pacific region, North America and Europe who are particularly affected as major lessors.

Disclosure

Some banks noted the fact that the overall impact of new and enhanced disclosure requirements is likely to be high. Regulators and investors across the world have had a significant interest in banks' disclosures in recent years. Demand for better disclosure around sovereign debt and commercial real estate exposure has followed hard on the heels of the earlier focus on banks' sub-prime debt. Since last year's survey, the Financial Stability Board set up the Enhanced Disclosure Task Force (EDTF), which published its report, 'Enhancing the risk disclosures of banks' in October 2012. The EDTF made recommendations for risk disclosures including market, credit, capital and liquidity risks.[1] As banks implement the recommendations, it is likely to result in changes to their existing external risk reporting; depending on their current disclosure practices this change could be significant.

1 For an overview, see our briefing paper, 'Promoting Stability' (Deloitte, 2012).

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?



Some banks were confident that national implementation by banks would be consistent, but that international comparability could not be achieved. Others expressed reservations about whether banks, auditors and regulators would all interpret IFRS 9 in an identical way.

There was no consensus amongst banks on this question. Many of the banks surveyed felt that the industry could meet the requirements of IFRS 9 and maintain comparability. However, a significant minority of respondents had more confidence in the industry's ability to meet requirements adequately, than in this leading to comparability between banks. Indeed there is less confidence than last year that comparable implementation will be achieved, perhaps because the developments around impairment are complex. Participants noted the fact that, depending on the objective of the business model, the accounting outcome might be different.

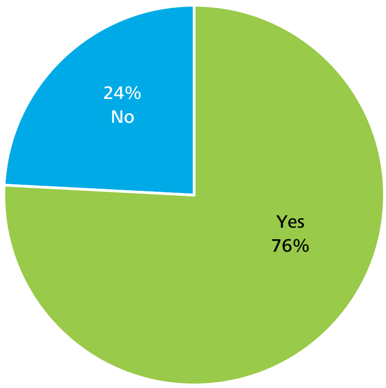
Uncertainty around how the components of IFRS 9 interact when finalised adds to doubt around how the requirements will be implemented by different banks, and was commented on by many of those who were not sure if comparable implementation could be achieved. Some banks were confident that national implementation by banks would be consistent, but that international comparability could not be achieved. Others expressed reservations about whether banks, auditors and regulators would all interpret IFRS 9 in an identical way.

IFRS 9 – Timetable, endorsement and convergence

The mandatory effective date for IFRS 9 was pushed back to 1 January 2015 by the IASB in 2011. Since then, banks have generally been working towards implementation on that date. However, the majority of respondents to this year's survey think that the timeline will be deferred further. The slow pace of progress on impairment and the re-opening of IFRS 9 on classification and measurement, difficulties in finding common ground with the FASB and uncertainty around the EU endorsement process for banks listed in the EU are factors contributing to this. In addition, the long-awaited – and still forthcoming – phase II insurance standard was highlighted as a potential source of delay. Although the insurance timetable is likely to be a few years later than IFRS 9, so that it is effectively decoupled from the financial instruments project, delay could arise from changes needing to be made to capture the accounting information most relevant to insurers. For example, the introduction of a fair value measurement category for debt instruments proposed in the classification and measurement amendments to IFRS 9 published in November 2012 is partly due to the need for insurers to apply accounting that minimises the accounting mismatch between their financial assets and insurance liabilities.

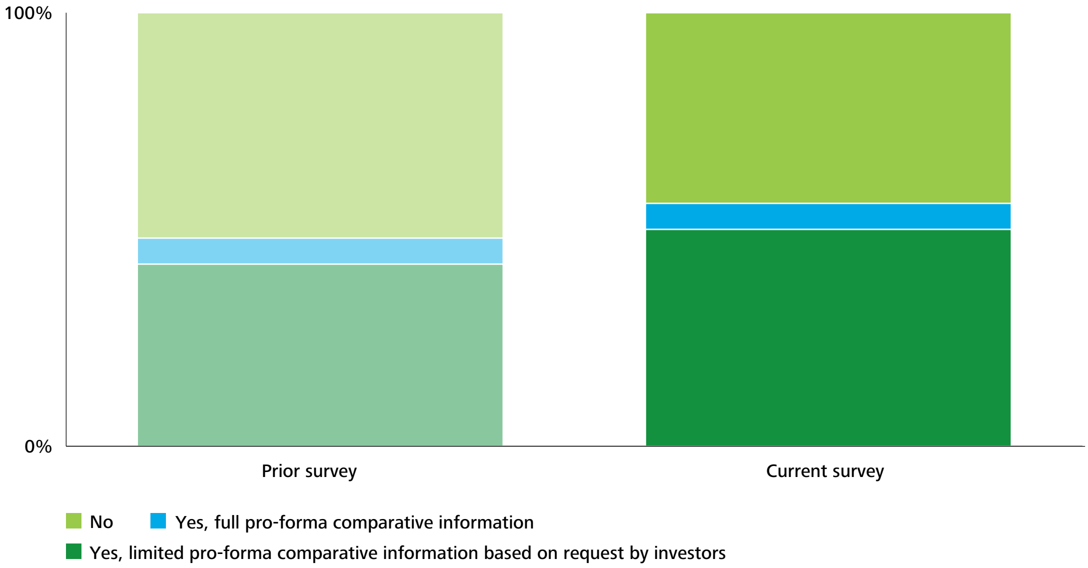
... the majority of respondents to this year's survey think that the timeline will be deferred further.

Figure 6. Do you think the IASB's mandatory effective date for IFRS 9 will be deferred further?



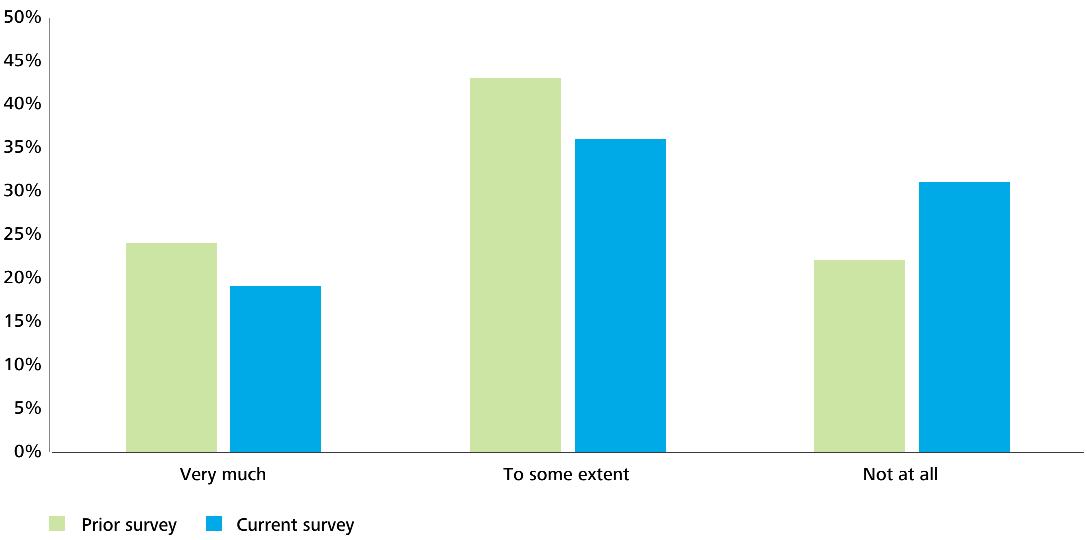
The view that deferral beyond 2015 is likely may be contributing to the relatively relaxed attitude banks appear to have about the timing of their IFRS 9 implementation projects (discussed below): most banks do not now plan to start their projects until the second half of 2013 or later knowing that comparative information will not be required in the first year of application. Banks may prefer to defer their implementation efforts until the final standards are issued, and thus may consider deferral will be necessary to allow sufficient preparation.

Figure 7. Do you expect to provide pro-forma information showing restated comparatives for investors even though it is not required by the standard?



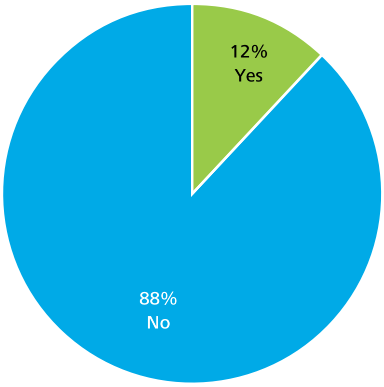
Comparative information that complies with IFRS 9 is not required in the first year of IFRS 9 application. Yet, consistent with last year's survey, a significant minority plan to provide this anyway. A larger proportion of banks are planning to give limited pro-forma information than when the question was last asked.

Figure 8. How much would the early adoption by your peer group influence your decision?



The decision to adopt early is – unsurprisingly – influenced by whether a bank's peer group would early apply. Since the previous survey there has been an increase in those that do not consider they will be influenced by their peer group. This may reflect the fact that as the effective date draws closer it will be more difficult operationally to adopt early, particularly with respect to impairment. Or, that banks are more confident in their own views; not needing to bow to pressure from others. (Some of the banks in the survey operate in a jurisdiction that does not allow early adoption.)

Figure 9. Do you believe the IASB and FASB will converge their financial instruments standard?



The vast majority of banks surveyed do not now believe the IASB and FASB will converge their financial instruments accounting standards.

The vast majority of banks surveyed do not now believe the IASB and FASB will converge their financial instruments accounting standards. Reasons for banks' lack of confidence in convergence include the Boards' disagreement on matters of principle, specifically in relation to the time horizon for recognising expected losses for impairment, where discussions have already extended for a protracted period. In addition, significant deliberations on impairment are now being undertaken independently by FASB and the IASB. To date, the convergence success stories for financial instruments have been limited to disclosures about offsetting and derecognition. The differing views of the IASB and FASB on the expected loss model for impairment have resulted in banks being less confident that convergence can be achieved for measurement. The US Securities and Exchange Commission has been discussing for some time the integration of IFRS into the US for domestic registrants (already permitted for foreign registrants), but has not committed to a particular timeline or outcome. Some consider this has contributed to a loss of momentum in the project to converge accounting standards[2].

The pessimism around convergence is not because banks are opposed to convergence: on the contrary, in responses to last year's survey, 46% of banks wanted convergence in all material respects, with smaller groups preferring divergence in measurement or disclosure.

If the Boards do not converge this will likely be cited as creating an unlevel playing field between banks in the US and IFRS reporters. There would be an increase in cost for banks needing to report under both sets of standards, for example at subsidiary and group level. Benchmarking may be harder for banks, and it would remain difficult for users to compare performance.

2 For more on convergence, see S. Sakr, 'Whether through conversion or convergence – accounting is moving on', *Euromoney,* Global Banking and Financial Policy Review 2012/2013 (October 2012).

Classification and measurement

In this survey we were interested in learning more about two particular issues: how banks thought they would account for instruments held for liquidity purposes under IFRS 9, and whether they would be inclined, if it were possible, to adopt early the provisions of IFRS 9 allowing designation of financial liabilities at fair value through profit and loss with movements in own credit risk being taken to other comprehensive income. We look at each in turn below.

The interaction of developments in the regulatory and accounting frameworks has been an area of concern for banks, including for IFRS reporters applying the Basel framework. A specific issue has been the accounting classification and measurement of financial assets held for liquidity and capital purposes, where the removal of the prudential filter by Basel for items in other comprehensive income is thought likely to increase volatility in banks' capital requirements.

Instruments held for liquidity purposes

IFRS 9 as currently drafted as a final standard on classification and measurement does not contain the requirement (nor the choice) to measure debt instruments held at fair value through other comprehensive income (FVTOCI). This is currently included in IAS 39 within the Available For Sale (AFS) category. Prior to the adoption of IFRS 9 and without a prudential filter for calculating banks' capital requirements the fair value gains and losses in OCI for AFS debt instruments will create regulatory capital volatility. Even with the adoption of IFRS 9 this regulatory capital volatility would continue if the assets that were previously measured as AFS are measured at fair value through profit and loss (FVTPL) under IFRS 9. Therefore knowing the banks' views on the application of IFRS 9 to liquidity portfolios is of significant interest in understanding the regulatory capital impact of applying IFRS 9.

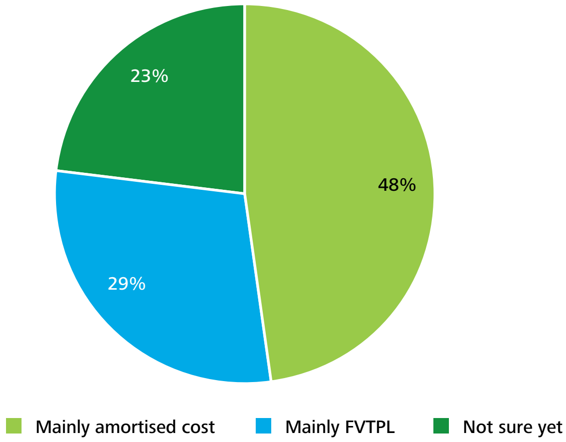
FASB's position on classification and measurement:
The key aspects of the FASB's model for classification and measurement of debt-instrument financial assets are substantially converged with the IASB's model in IFRS 9. Both models require an entity to consider the cash flow characteristics of a debt-instrument financial asset and the business models in which assets are managed.

However, application guidance is expected to differ, such that the practical application of the respective models could also differ. Also, the boards' models for classifying and measuring investment in equity instruments are not converged.

Currently, and unlike IFRS, in the United States there is specialised industry guidance for depository institutions and mortgage banks which is included in Accounting Standards Codification 942 and ASC 948, respectively. This guidance addresses the initial and subsequent measurement of several different financial instruments. The FASB has tentatively decided to supersede this specialised industry guidance. As a result, depository institutions and mortgage banks will apply the FASB's tentative model or existing US GAAP guidance that is not unique to a specific industry.

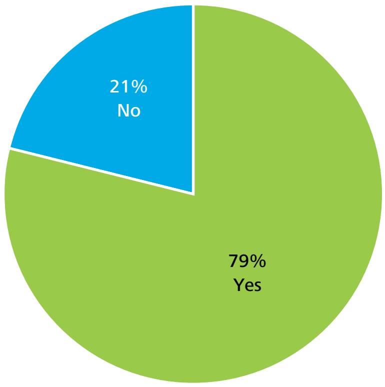
At the date the banks were surveyed, the IASB had not issued its recent exposure draft. However, banks were aware of the objective of the proposals. Against the background of uncertainty as to how to account for liquidity portfolios, the survey asked banks to describe whether they considered the exposure draft, if finalised, would change the accounting for these assets.

Figure 10. Based on IFRS 9 classification and measurement (without the proposed fair value through other comprehensive income for debt instruments category), how do you expect the assets you hold to meet regulatory liquidity requirements (excluding trading assets) to be classified?



Almost half of banks surveyed thought the assets held for regulatory liquidity requirements would be held at amortised cost under the current version of IFRS 9 against just less than a third who believe they would be held at FVTPL. A fifth of banks were not certain: we had expected a higher proportion to indicate uncertainty, as there have been calls for more clarity in this area. The IASB has responded to these calls by issuing an exposure draft in November 2012 that proposes changes to IFRS 9 by introducing a FVTOCI category for debt instruments and also clarifying the implementation guidance on the amortised cost definition.

Figure 11. If the IASB goes ahead with the proposed FVTOCI category for debt instruments, do you expect a significant proportion of the assets you hold to meet regulatory liquidity requirements (excluding trading assets) to be classified as FVTOCI?



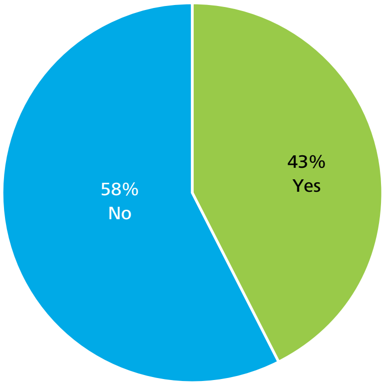
Over three quarters of respondents expected a significant proportion of assets held to meet liquidity requirements to be classified as FVTOCI. Almost half of those expecting to classify a significant proportion of their non-trading assets as FVTOCI would otherwise have held them at amortised cost. This shows the banking sector's expectation that introducing the FVTOCI category will increase fair value measurement when compared to the current version of IFRS 9. This could lead to a conclusion that IFRS 9 as proposed to be amended would result in more regulatory capital volatility. However, such a conclusion does not reflect the fact that, relative to IAS 39, the proposed amendments to IFRS 9 may in fact be regulatory capital neutral with respect to classification. Many of the assets that would be measured at FVTOCI under the proposed amendments to IFRS 9 are currently measured the same way as AFS assets under IAS 39.

Own credit risk

During the financial crisis regulators and investors were critical of the IASB's and FASB's accounting standards that resulted in fair value gains being recognised due to deterioration in the credit risk of a bank. This arose due to the way fair value gains and losses were presented in profit or loss for certain financial liabilities. Many do not like bank earnings to be so heavily influenced by changes in the credit quality of the reporting bank. Some of the world's largest banks were amongst those to speak out against this, raising the matter in the financial press and asking standard setters to make amendments to the accounting requirements.

The IASB has responded to these concerns by introducing into IFRS 9 a requirement that fair value gains and losses due to changes in an entity's credit risk for certain non-derivative financial liabilities be recognised directly in other comprehensive income rather than going through the income statement. Some of the IASB's constituents have sought an earlier end to the current disliked accounting treatment by pushing for a change to IAS 39. However, the IASB have instead proposed in their recent exposure draft of changes to IFRS 9 (published in November 2012) that an entity could apply the requirements for fair value changes in own credit to be recognised in OCI by early adopting just that part of IFRS 9. This year's survey sought banks' views on this.

Figure 12. If the IASB's proposed change to IFRS 9 allowing early adoption of the requirement to take fair value changes in own credit on certain debt instruments to other comprehensive income is finalised, would you early adopt this?



This year's survey found that a significant proportion of banks would be interested in early adoption of the own credit requirements only, confirming the IASB's logic for proposing an amendment to the standard in this area. Banks answering 'yes' to this question included some banks for which the reported effect of fair value changes in own credit risk have historically been significant. Those that answered 'no' to early adoption include some banks that would not be permitted to adopt early in their jurisdiction. Other banks gave a provisional 'no' response, but might early adopt depending on the amount of own credit change at the time. Indeed, an explanation for the high proportion of banks that would not early adopt this change is that they do not expect to see a continuation of the large variations in own credit risk that have occurred in recent years.

Impairment

Impairment is proving to be one of the most challenging accounting issues around which to achieve a consensus. To date, the IASB and the FASB have invested significant time and effort in trying to find a position both Boards can support and which would be acceptable to their constituents, but in recent months reaching a consensus has proved increasingly difficult. Both Boards support an expected loss model – in material respects, but disagree about how it should be designed. In particular, the IASB has focussed on the notion of a dual measurement approach whereby the time horizon for measuring expected losses increases when credit risk deteriorates. In contrast, the FASB prefer a single measurement approach whereby credit deterioration does not feature as a condition for recognising lifetime expected credit losses.

FASB's position on impairment

During the July 2012 joint meeting the FASB announced that its constituents were concerned that the joint model was difficult to understand, operationalise and audit. As a result, the FASB decided to begin developing an alternative impairment model. This model was put out for comment as our survey went to press.

The FASB's alternative impairment model would apply to all financial assets measured at amortised cost or FVTOCI (like the IASB's model). Under the model, a reporting entity would recognise an impairment allowance equal to the current estimate of expected credit losses (CECL) for such assets as of the end of the reporting period. The estimate of current expected credit losses would be required to:

- Represent an expected value. In other words, a probability-weighted amount that considers at least two possible outcomes, not a best- or worst-case scenario determined by the entity.
- Reflect all supportable internally and externally available information considered relevant in making the forward-looking estimate, including information about past events, current conditions, and reasonable and supportable forecasts and their implications for expected credit losses.

All changes in a reporting entity's estimate of expected credit losses would be reflected as impairment expense in the period the change occurred. As a practical expedient for financial assets measured at FVOCI, the FASB decided that an entity would not be required to recognise an impairment allowance for such assets if both of the following conditions are met:

- The fair value of the financial asset is greater than its amortised cost.
- The amount of expected credit loss is insignificant.

They introduced this due to the concerns of some Board members that the CECL model would result in the recognition of an allowance for assets that (1) are of high credit quality and (2) could be sold at a gain (e.g., certain debt securities).

A reporting entity would apply nonaccrual accounting of interest when it is no longer probable that the entity will receive full payment of principal or interest.

The Boards' proposals share the common concept of recognising expected credit losses based on a probability weighted assessment of contractual cash flows not expected to be recovered and incorporating the time value of money. The FASB model applies this concept to all financial assets in the scope of the impairment model but unlike the IASB would not create separate measurement basis (or 'buckets') depending on what the credit quality is at a given measurement date. In contrast, the IASB's model would apply a dual measurement approach with impairment being measured on the basis of lifetime expected credit losses for some assets and for other assets on the basis of credit losses expected to arise from loss events in the next twelve months only. Under the IASB's current thinking, measurement based on lifetime expected credit losses would be required for all financial assets credit impaired at initial recognition and for those that had met the test for transfer to the lifetime expected losses measurement bucket. The IASB has recently simplified the basis for this transfer to only one criterion, namely that there has been significant deterioration in credit quality since initial recognition (taking into consideration the term of the asset and the original credit quality). Assets that did not meet this transfer notion and were not credit impaired at initial recognition would reflect impairments based on expected credit losses arising from loss events within the next 12 months.

On 20 December 2012 the FASB issued an Accounting Standards Update (ASU) which sets forth full details of the current expected credit loss model. The ASU is open for comment until 30 April 2013. The IASB's proposals (sometimes referred to as the dual measurement approach) are expected to be published in the first quarter of 2013.

Depending on the publication dates and comment periods granted, constituents (including banks) may be able to contemplate both models alongside each other before responding to the Boards. In anticipation of their release this year's survey asked banks which model they preferred, and why.

Figure 13. Of the impairment models currently deliberated by the IASB and FASB, which do you prefer?

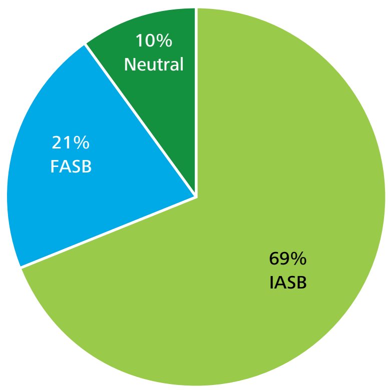
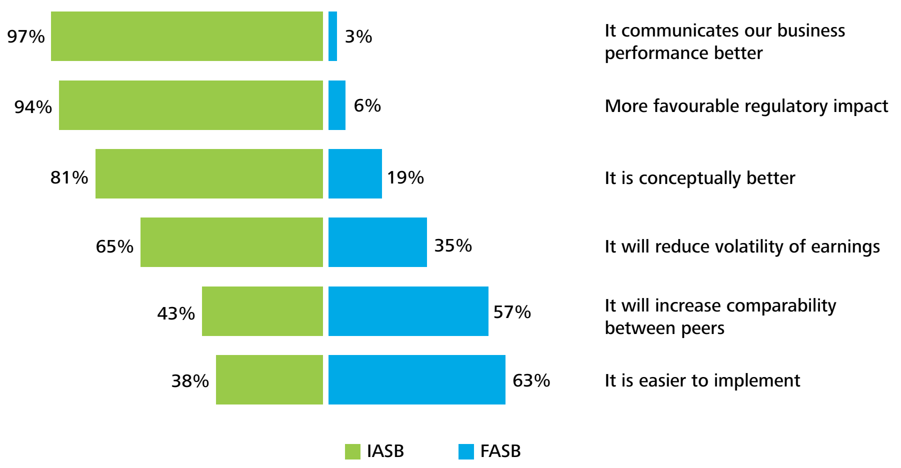


Figure 14. Why?

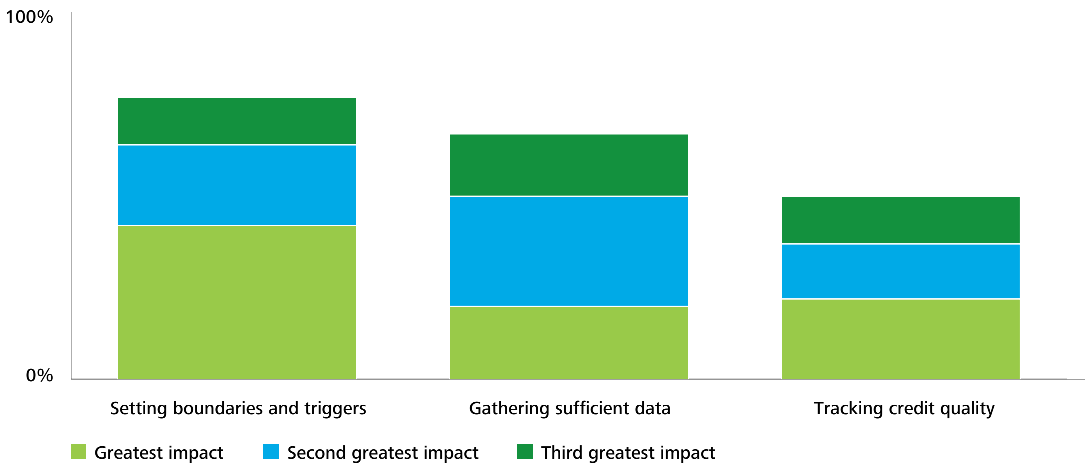


A large majority of banks favoured the IASB model. (However, this year's survey was aimed at IFRS reporters so respondents are more familiar with the IASB approach and this may contribute to their preference.) The support for the IASB's approach relative to the FASB's proposals was justified by a combination of very different reasons including: better communicating business performance, being conceptually superior, reducing earnings volatility and having a more favourable regulatory impact.

Those banks favouring the FASB model most often justified this by pointing to increased comparability among peers and easier implementation. The argument for increased comparability is that the FASB approach does not contain any requirement to transfer between different measurement buckets thus avoiding the interpretation complexity this may bring. The support for the FASB model did not come solely or indeed principally from banks in North America. Many Canadian banks preferred the IASB approach or were neutral, whilst a number of banks outside North America, together with those in the US, indicated that they preferred the FASB approach. Banks that did not like the FASB approach singled out the recognition of lifetime expected losses at initial recognition (sometimes referred to as day one losses) as a particular concern.

Some banks were not satisfied with either approach, indicating that they are both currently too unclear, too complicated or not aligned closely enough with regulatory reporting.

Figure 15. What is the biggest challenge in implementing the IASB's proposed expected loss model?



In recent Board meetings the IASB has spent time discussing how the requirement to transfer from 12 months of expected losses to lifetime expected losses might be refined in response to feedback on this issue from outreach efforts. In this context it is not surprising that the single biggest challenge in implementing the IASB's expected loss model is the setting of boundaries and triggers for transfers between buckets. Under the proposed FASB single measurement approach the issue of transfer boundaries is not relevant as there is only one impairment measurement basis. Gathering sufficient data for future forecasts of the variables driving credit losses is the issue perceived as the second biggest difficulty, despite the need to capture this information for the purposes of credit risk management. This would apply equally to the IASB and FASB models. The third greatest impact would be the tracking of credit quality, a feature relevant to the IASB model, not the FASB model, as it is the IASB expected loss model that is based on credit deterioration whereas the FASB model is not. These responses are consistent with the overall conclusion that two-thirds of respondents considered the FASB expected loss model easier to implement when compared with the IASB's expected loss model (Figure 14).

The past five years have seen an unprecedented level of interest in the loan impairment charges banks disclose and how these amounts are calculated. Impairment disclosures for sub-prime mortgages, sovereign debt and commercial real estate have been important in enabling users to assess the credit risk to which a bank is exposed. Regulatory authorities have been similarly focussed on the quality of disclosure in this area, and the Securities and Exchange Commission, European Securities and Markets Authority and the UK's Financial Services Authority are amongst those to have taken steps to increase the quality and consistency of impairment disclosure by banks. Forbearance strategies and returned to performing (cured) loans remain very much in the spotlight. The recent EDTF report included recommendations to develop impairment disclosures further in this area. Given the focus on impairment and credit risk disclosures, we were interested in understanding how confident banks feel about meeting the IASB's forthcoming disclosure requirements which form part of the impairment reforms, and what they regard as the challenges in developing these disclosures.

Tentative Proposals for Impairment Disclosure (based on IASB Meeting Staff Paper 5b, October 2012)

The disclosure objectives for the proposed expected loss model are:

(a) to enable a user to understand an entity's estimate of expected losses, and

(b) to enable a user to understand the credit quality migration of financial assets.

In meeting the above objectives, the IASB and FASB have tentatively decided to require an entity to disclose:

(a) The inputs, assumptions and techniques used in:

  (i) estimating expected losses; and

  (ii) assessing whether the recognition of lifetime expected losses have been met.

(b) Information regarding the quality of collateral.

(c) Quantitative information related to collateral for financial assets for which lifetime expected losses are recognised. The IASB would limit this disclosure to financial assets that are credit-impaired .

(d) A reconciliation of the beginning and ending balances, disaggregated by whether the impairment allowance is measured using 12 months' expected losses or lifetime expected losses, of:

  (i) gross carrying amounts; and

  (ii) impairment allowance balances.

(e) A narrative discussion of changes in the impairment allowance balance.

(f) A disaggregation of the gross carrying amount by credit quality both for financial assets with an impairment allowance measured at 12 months' expected losses and lifetime expected losses (including a description of how the entity determines the categories of credit quality). For the IASB, these disclosures would be required only if other more granular disclosures related to credit risk profiles are not already required by regulators (e.g., Basel III).

(g) Amounts related to purchased credit-impaired assets.

(h) The balance of financial assets evaluated on an individual basis and for which impairment is measured at lifetime expected losses and the allowance balance related to these financial assets.

In addition the IASB tentatively decided to require that an entity disclose:

(a) qualitative information related to the discount rate elected;

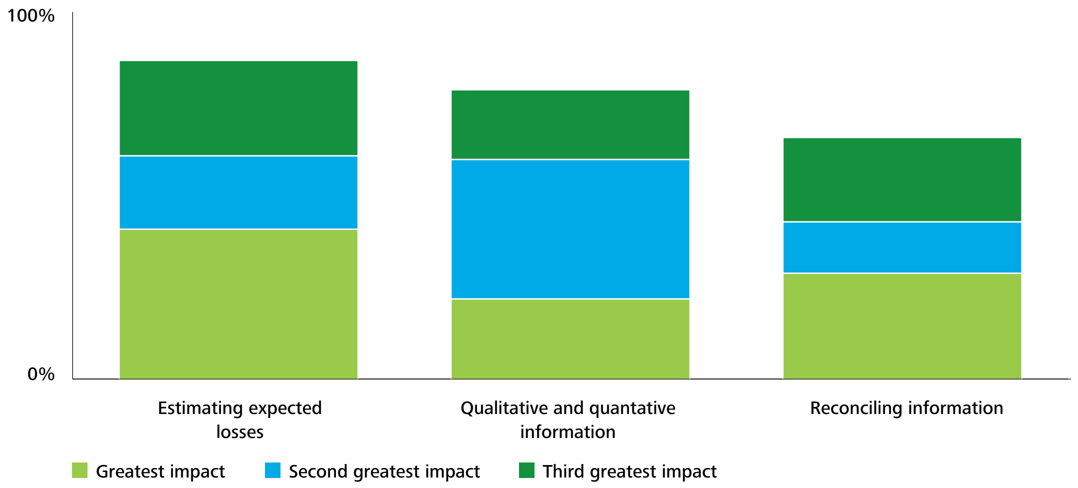
(b) information regarding financial assets for which an impairment allowance of lifetime expected losses is required that have been modified at any time in their life.

(c) the gross carrying amount and related allowance, if any, of financial assets measured under the impairment model if a default has occurred;

(d) the balance of financial assets 90 days past due with an impairment allowance measured at 12 months' expected losses; and

(e) the amount of interest revenue and how it is calculated (ie gross, net, credit-adjusted EIR).

Figure 16. Based on disclosure requirements relating to the IASB's impairment proposals as currently known, which of the following do you think will be most challenging?



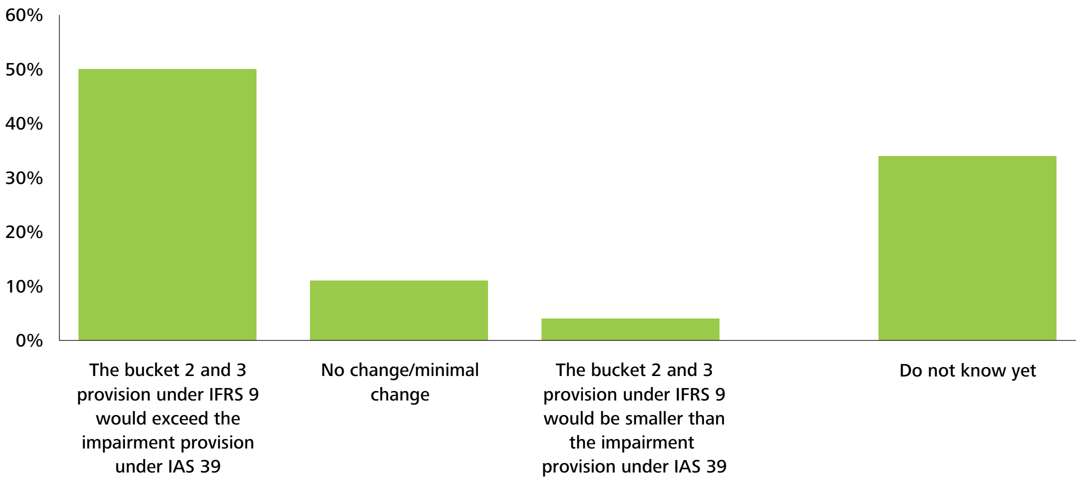
The areas banks were asked to comment on were:

- The inputs, assumptions, and techniques used in estimating expected losses;
- Qualitative and quantitative information relating to collateral;
- A reconciliation of the opening and closing carrying value that includes the change in impairment allowance, write offs and recoveries; and
- Disclosure related to purchased credit impaired assets.

The inputs, assumptions and techniques used in estimating expected losses are perceived as the biggest challenge. This is consistent with last year's survey, which highlighted estimating expected losses and disclosure as particular challenges.

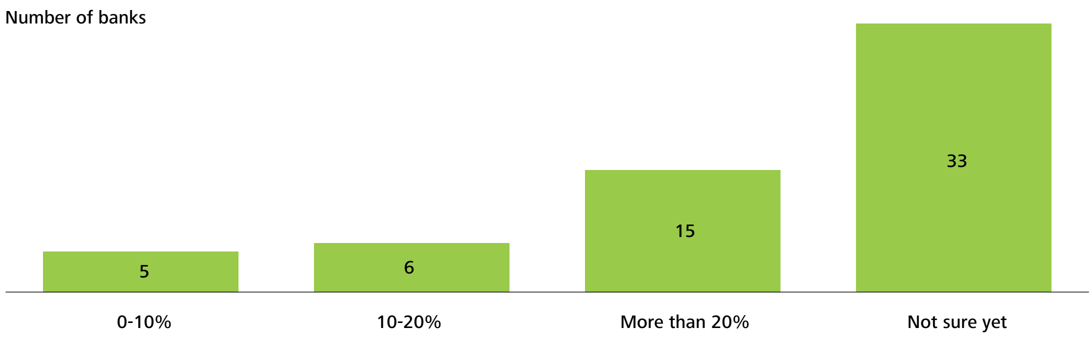
Increasing the amount of information relating to collateral is also identified as challenging by the banks. The EDTF as well as a number of local regulators have indicated collateral disclosure could improve. More specifically, the EDTF recommended qualitative information on credit risk mitigation, including collateral for all sources of credit risk, should be given in sufficient detail to allow an assessment of the quality of collateral. It also recommended improvements to over the counter derivatives collateral disclosure. We expect to see change to banks' collateral disclosures, driven by these demands.

Figure 17. As at the most recent balance sheet date, would you expect total bucket 2 and 3 provision based on the IASB's proposed expected loss impairment models to differ from your impairment provision under IAS 39?



Half the banks surveyed expect the provisions under bucket 2 and 3 of the IASB model to exceed impairment provisions calculated under IAS 39. This indicates that they expect the definition for buckets 2 and 3 to be broader than the current 'incurred but not reported' approach currently in use under IAS 39. When aggregated with the 12 months' expected losses in bucket 1 it is clear and not unsurprising that most banks' cumulative impairment provisions would be higher under the IASB's provisions compared with the current impairment standards. A third of banks do not yet know whether the total impairment for buckets 2 and 3 will be larger than currently experienced under IAS 39. This likely reflects uncertainty reflected in recent feedback to the IASB about what is the criteria for transferring from bucket 1 to 2 and therefore how the proposals relate to current practices under IAS 39.

Figure 18. If you expected the bucket 2 and 3 provision based on the IASB's proposed expected loss impairment models to exceed the impairment provision under IAS 39, please quantify the impact.



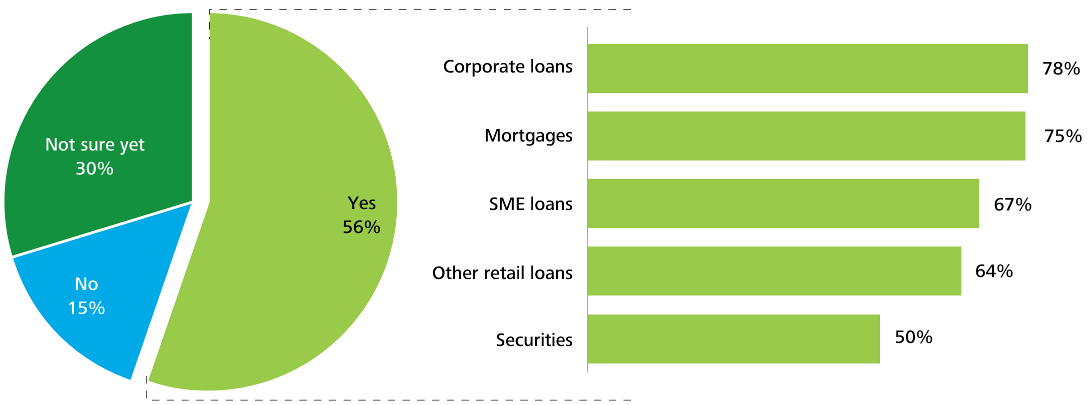
Over half of those who expected the cumulative impairment provision for buckets 2 and 3 to exceed the impairment provision under IAS 39 were not able to quantify the size of this increase. This suggests quantitative impact assessments have yet to be performed. This is not unsurprising considering the IASB continue to finesse the bucket 1 to 2 transfer criteria in advance of publishing their forthcoming exposure draft in the first quarter of 2013. Where the line is drawn between bucket 1 and 2 is critical. One bank said that if the threshold for bucket 2 were to be just below investment grade, it would expect the total provision for bucket 2 and 3 to be 20% higher than is currently recognised in IAS 39. Nevertheless, even a simple average of the data would imply an increase in provisioning in buckets 2 and 3 of between 15% and 20%.

… even a simple average of the data would imply an increase in provisioning in buckets 2 and 3 of between 15% and 20%.

Transitional reliefs for impairment

At the IASB's July 2012 meeting the Board tentatively agreed that the impairment model would be applied retrospectively. This would involve banks determining the expected losses at the date assets were initially recognised and then tracking changes in credit quality since then. However, the Board also agreed an initial relief if an entity could not, due to undue cost or effort, gather the necessary data. The transition relief would require that financial assets be evaluated only on the basis of the second criterion of the bucket 1 to bucket 2 transfer definition: "the likelihood that contractual cash flows may not be collected is at least reasonably possible".

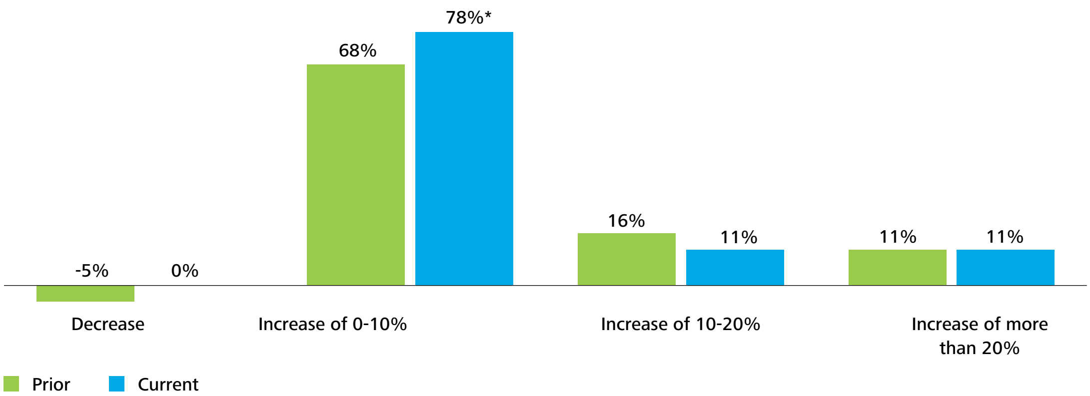
Figure 19. Do you expect to take advantage of the transition provision relief that allows exemption from retrospectively tracking your portfolios? And, if yes, for which of the following portfolios?



This year's findings show that 56% of banks surveyed intend to take advantage of the relief. There was no clear regional difference in responses to this question. Some banks will take the relief for one or two portfolios only; others plan to use it for all of them. The overall picture is that banks will use the relief more for their lending portfolios than for securities.

A significant proportion of banks consider the new impairment rules will not result in a significant change to regulatory capital. This was a surprise conclusion particularly in light of so many banks also claiming that the cumulative provision for buckets 2 and 3 would be larger than the impairment approach under IAS 39 (see Figure 17). Yet, 22% of respondents considered the increase in regulatory capital would be in excess of 10% – a sizeable increase. What is clear is that none of the banks are expecting a reduction in regulatory capital requirements whereas in the prior survey a small minority did.

Figure 20. For strategic planning purposes, what is your best estimate of the change in regulatory capital requirements resulting from the transition to the IASB's proposed impairment model?



* From the 78%, 41% found it was not significant

Overall, with the exception of securities, more banks thought pricing would probably or potentially change than that it would not be affected. Many of those that did not expect a change in pricing commented that expected losses are already included in their pricing, so they would not expect a change as a result of different accounting for expected losses. However, the responses also highlighted the link between accounting numbers and regulatory capital requirements, with one bank stating there would be an increase in pricing 'potentially for an incremental cost of capital. However, technically the yield should already contemplate the expected losses.' The regulatory capital increases identified in Figure 20 are expected to drive up the price of lending.

Figure 21. Do you think moving to an expected loss impairment model will affect the pricing of the following products?

Respondents are less sure that initial pricing of securities will be affected by the introduction of an expected loss model. This may reflect that bank's objectives as an investor in securities differs to the pricing decision a bank will make in lending to a corporate, SME, or retail borrower.

General and macro hedge accounting

In September 2012, the IASB issued a near final-draft of the general hedge accounting requirements to be incorporated into IFRS 9. The draft primarily does not address the more complex portfolio (macro) hedge accounting which will be a separate project, with the first milestone to be an IASB discussion paper due out in 2013. Given the longer term nature of the macro hedge accounting project, the IASB has acknowledged that it will not be complete in time for the 1 January 2015 effective date of IFRS 9. As a result, the aim is for adopters of IFRS 9 to continue to use the IAS 39 macro fair value hedge accounting requirements until an alternative model is finalised. This separation of the macro hedge accounting project from the IFRS 9 timetable makes finalisation of IFRS in time for 2015 more feasible.

FASB position on hedge accounting
Although the IASB and the FASB continue to share the goal of improving their respective hedge accounting models and ultimately achieving a converged standard, they have taken different approaches and are separately developing proposals to simplify hedge accounting.

The FASB is also revisiting its existing hedge accounting model as part of its joint project with the IASB on accounting for financial instruments and proposed a number of changes to that model in its May 2010 exposure draft. The FASB's proposed changes differ significantly from the IASB's hedge accounting model described in the Staff Draft. The FASB has not yet begun redeliberating its hedge accounting model and it is unclear to what extent the Staff Draft will affect the FASB's discussions.

The FASB has no current plans to add macro hedging to its projects agenda in the near future, so this is currently an IASB-only topic.

General hedge accounting

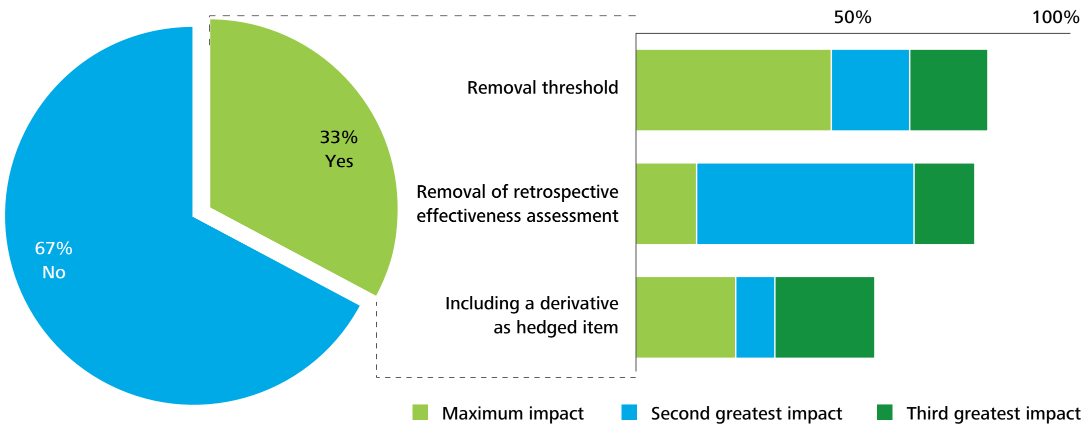
Looking first at the general hedging requirements, the IASB has been moving towards a less rules-based approach to hedge accounting that is more reflective of risk management practices than has been the case under IAS 39. To this end, it plans to introduce a number of changes designed to make hedge accounting more achievable for hedges entered into for risk management purposes. The relevance of the various changes for reporters will depend on their risk management activities and the way in which the current hedge accounting requirements are applied. For example, the changes to the general hedge accounting model will be of more relevance to those banks that use micro hedge accounting or macro cash flow hedge accounting as an alternative to macro fair value hedge accounting for interest rate risk.

The key area of change in the general model is in respect of the hedge effectiveness requirements. For hedges under the general hedge accounting model, there would no longer be any bright line effectiveness thresholds as the 80 to 125% band in IAS 39 would no longer apply. The requirement to perform a retrospective hedge effectiveness assessment to determine whether hedge accounting can be applied in the period would also be removed. The draft introduces a principles-based test that is applied prospectively, and requires there to be an 'economic relationship' between the hedged item and hedging instrument.

Other specific changes included within the draft are the removal of the prohibition that a derivative cannot be part of the hedged item; the introduction of less volatile accounting in profit or loss for changes in time value of an option when the intrinsic value is designated; and an elective fair value option for loans and loan commitments hedged for credit risk. (Further analysis of the IASB's general hedge accounting proposals can be found in 'A closer look' which can be found on iasplus.com.) We wanted to understand the impact of the IASB's changes on general hedge accounting for banks, and find out which changes will have most effect.

Figure 22. Based on the proposed IASB general hedge accounting draft, do you expect to do more hedge accounting?

If yes, which of the following areas of change proposed in the recent general hedge accounting draft issued by the IASB is likely to have the greatest impact on your decision?



One bank remarked that the level of inflation hedge accounting is likely to increase.

Two thirds of banks indicate that they do not expect to do more hedge accounting; the other third will increase the amount of hedge accounting they would do. These responses suggest that some banks will be taking advantage of the reliefs, including on effectiveness testing, which make qualifying for hedge accounting somewhat easier. One bank remarked that the level of inflation hedge accounting is likely to increase. Other banks have economic hedges that under both the current and proposed model are not eligible for hedge accounting. Given that most banks' micro hedges tend not to be problematic, this result is in line with expectations. The changes to macro hedge accounting are likely to have a greater effect and may further increase the level of hedge accounting banks undertake.

Those who expect to apply more hedge accounting under the general model cited as their main reasons the removal of the 80-125% effectiveness threshold and the removal of the requirement to perform retrospective effectiveness assessments. This is consistent with expectations: less onerous testing requirements will allow more use of hedge accounting. What is more surprising is that the ability to include a derivative as part of the hedged item was cited by over half of those who are planning to do more hedge accounting as one of the top three reasons for applying more hedge accounting under the general model. It will be interesting to see the types of hedging scenarios to which banks plan to apply this rule change.

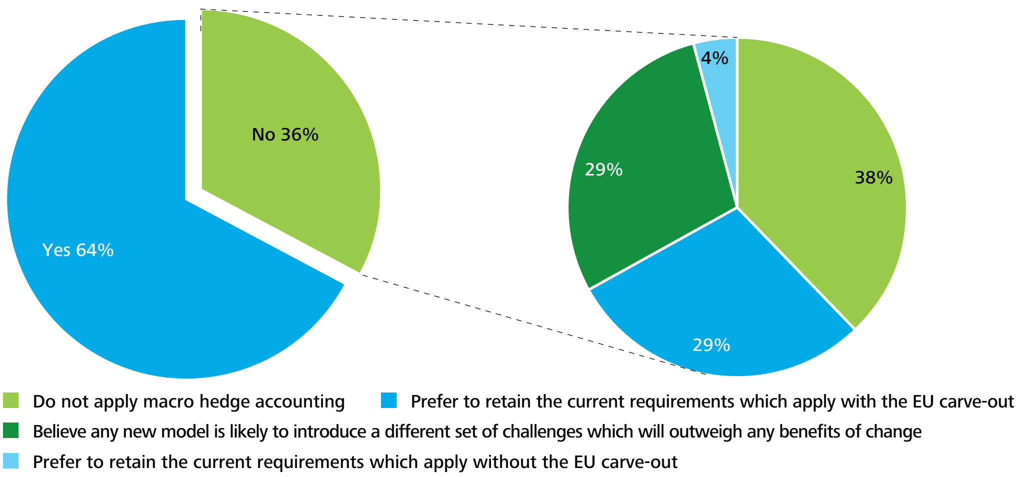
Macro hedge accounting

… have been criticised for being operationally and technically complex to apply, yielding results that are not always understandable, and generally not reflective of the risk management activities of the entities that apply them.

The area of hedge accounting most relevant for banks is macro hedge accounting. As mentioned above, these rules remain unchanged for now. Hence, banks applying macro fair value hedge accounting under IAS 39 will continue to be subject to the 80-125% threshold and the other complex mechanics until an alternative model is developed. Ever since these macro hedge accounting rules were introduced, they have been criticised for being operationally and technically complex to apply, yielding results that are not always understandable, and generally not reflective of the risk management activities of the entities that apply them. This year's survey asked banks what they thought of existing accounting requirements relating to portfolio hedging, and what changes they would like to see.

Figure 23. Do you think the IASB should change the current macro hedge accounting requirements in IAS 39?

If no, why not?



Two thirds of participants think the IASB should change its requirements. Of those who do not want change, 38% are not applying macro fair value hedge accounting and it would appear they do not think a new project on the macro model would be useful to them. Of those not currently applying macro fair value hedge accounting, some are likely to be applying macro cash flow hedge accounting or micro hedge accounting as an alternative and are likely to continue to do so. Almost a third of those who did not want change are reporters using IFRS applying the EU carve out and therefore would prefer to retain the flexibility that the carve out offers rather than apply an alternative macro hedge accounting approach.

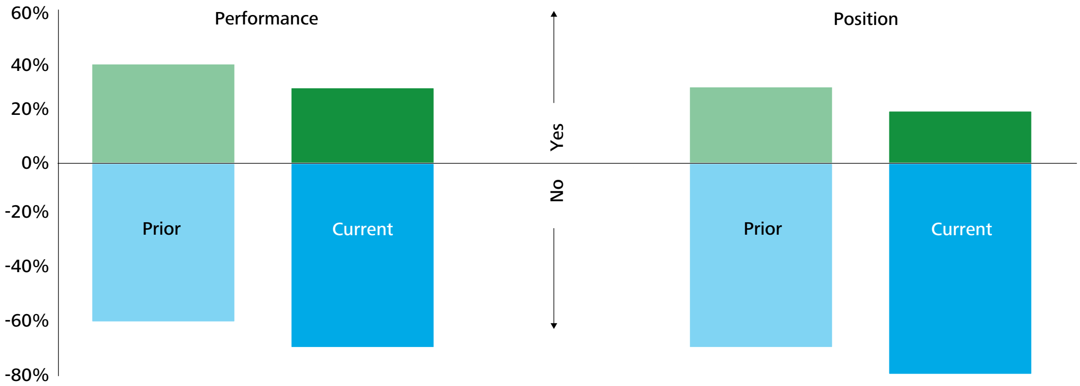
Yet the majority of banks support change in macro hedge accounting. This means that even if the financial instruments project, excluding macro hedge accounting, is finalised in 2013, demand from banks for further change is likely to continue. The main reason for wanting change which was cited by a number of banks is to better align their financial reporting with their risk management activities. This was the underlying objective of the general model and is the same target the IASB has for the macro model. However, fixing the macro model will be far more challenging. For example, a number of respondents would like the IASB to develop a model where internal derivatives can be used as hedging instruments; demand deposits can be included as hedged items; and a bottom layer approach can be used to reduce the impact of prepayment on hedge ineffectiveness. The aim of all this would be to capture banks' risk management and reporting objective of stabilising net interest margin.

Some banks stated that a revised model based on cash flow hedge accounting principles should be pursued. This is somewhat surprising as it tends not to be the generally favoured approach due to the volatility in equity that remains. Nevertheless, such an approach would address many of the mechanical issues that arise from fair value hedge accounting (which requires constant posting and amortisation of hedge accounting adjustments).

IFRS 9 – Impact on financial statements

As noted above the banks that took part in this year's survey generally preferred the IASB's expected loss model to the FASB's. We also wanted to hear what banks thought of the IASB's proposals for IFRS 9 compared to their current accounting.

Figure 24. Based on what you know now about IFRS 9 and the Boards' deliberations, do you expect IFRS 9 more accurately to reflect the financial performance and financial position of your firm?

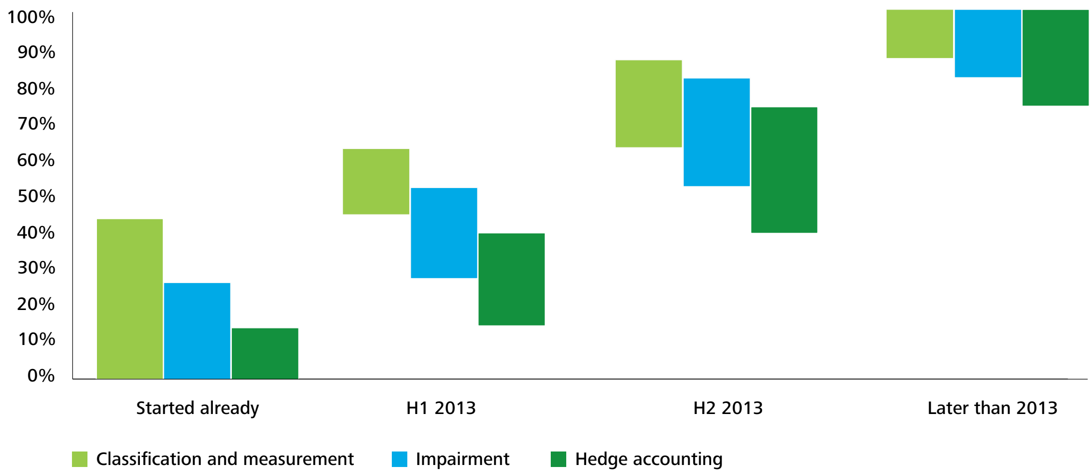


Around two-thirds of participants do not think the IASB's proposals will be an improvement in communicating their financial position and performance compared with the current application of IAS 39. Moreover, the overall proportion doubting whether the standard will accurately reflect their business has increased since last year's survey. This is a more critical view of the project than might have been expected. The reasons given were varied but included an on-going mismatch between accounting and risk management; dissatisfaction with the twelve-month bucket for impairment, (which was described as arbitrary and 'not based on a specific rationale') and continuing complexity. There was some uncertainty expressed in responses to this question, and several banks indicated that their final view of the IASB's work could change subject to what is contained within the final standard, including for example, in relation to the recycling of amounts recognised in OCI.

Amongst the third who thought IFRS 9 would more accurately capture their financial position and performance, the explanations included that less restrictive hedge accounting proposals will allow their accounting to be more closely aligned with their hedging strategy and impairment provisioning will allow better recognition of the risks inherent in their lending portfolios. Others thought that the recognition of fair value gains and losses on own credit risk in OCI would be a significant improvement.

IFRS 9 – Implementation

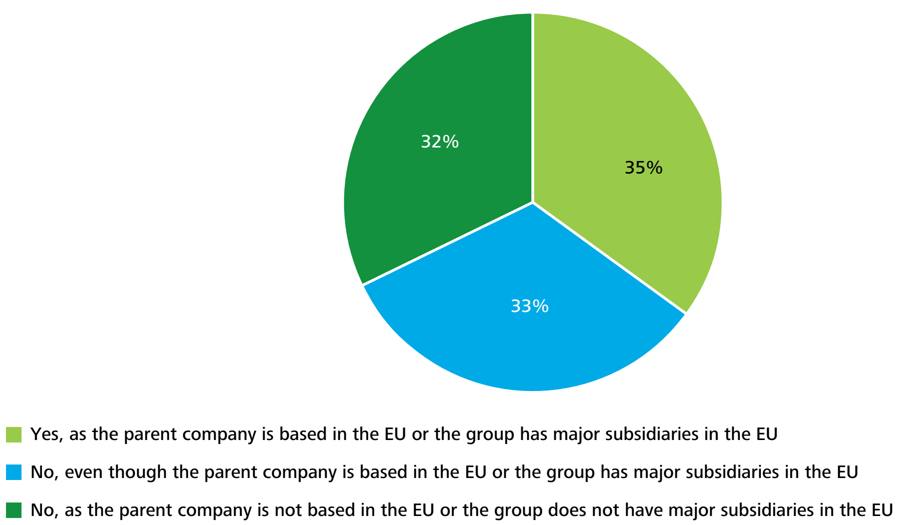
Figure 25. When do you expect to start your IFRS 9 implementation projects?



Banks are prioritising classification and measurement work above impairment and hedge accounting, consistent with their expectations around the completion of these projects by the IASB. Nonetheless, many are not planning to commence work until the second half of 2013 or later, on the understanding that the IASB will not have published finalised amendments on classification and measurement and the new impairment model until then. Indeed, compared to last year's survey, IFRS 9 implementation work generally appears to have been pushed back, as a larger proportion of participants are indicating 2013 or later than when last asked about this.

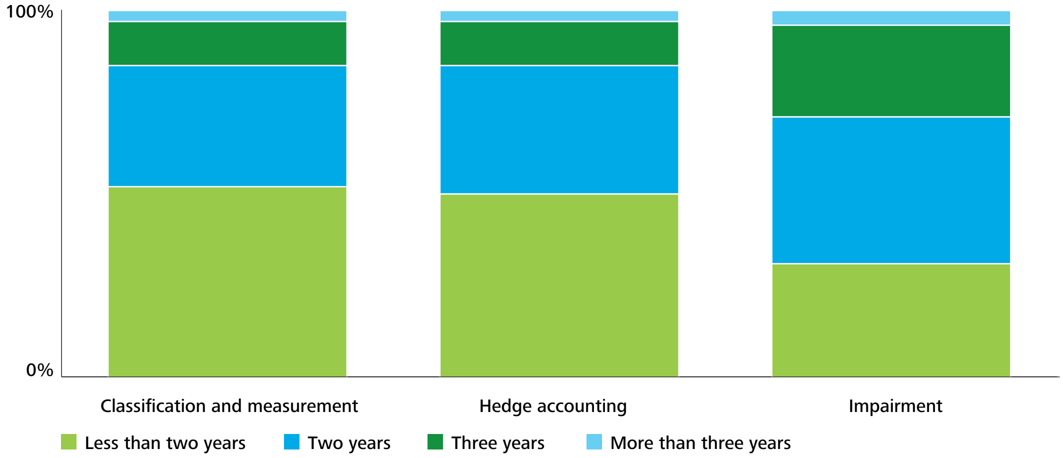
For those affected by the decision as to whether the EU will endorse IFRS 9 (when complete) this adds to the overall uncertainty. Excluding macro hedging, a finalised IFRS 9 would not likely be complete until the close of 2013 at the earliest. This is a small window in advance of the 2015 effective date.

Figure 26. Will uncertainty around EU endorsement process result in the postponement of a significant portion of your implementation project?



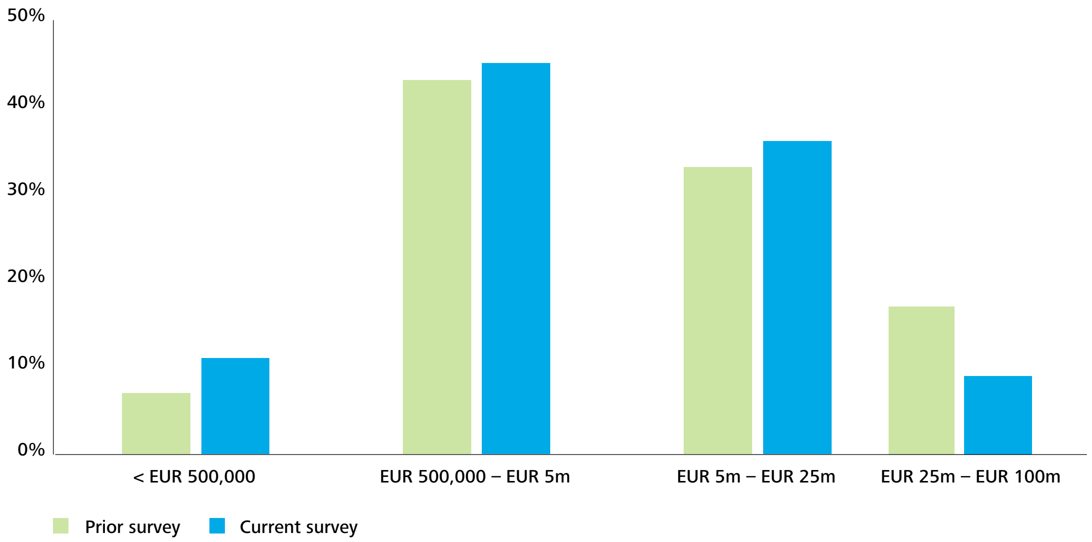
We asked banks how they are adjusting their implementation plans in the light of this uncertainty. Banks that considered the EU endorsement decision would potentially delay a significant part of their implementation tended to have the parent company based in the EU, and were typically neither G-SIBs nor SEC registrants. SEC registrants were more likely not to postpone, either because their group structure did not feature heavily in the EU, or because if it did, the SEC's filing requirements would require IFRS information based on that issued by the IASB and therefore banks could not avoid the application of a new IASB standard beyond the IASB's effective date. Although some banks headquartered outside the EU have significant EU subsidiaries, 32% of companies are unaffected by EU endorsement decisions. Nevertheless, of the balance, those choosing to postpone or not were finely balanced.

Figure 27. Excluding macro hedging and assuming the remaining phases of IFRS 9 are finalised in H1 2013. How much time do you require to implement the standard?



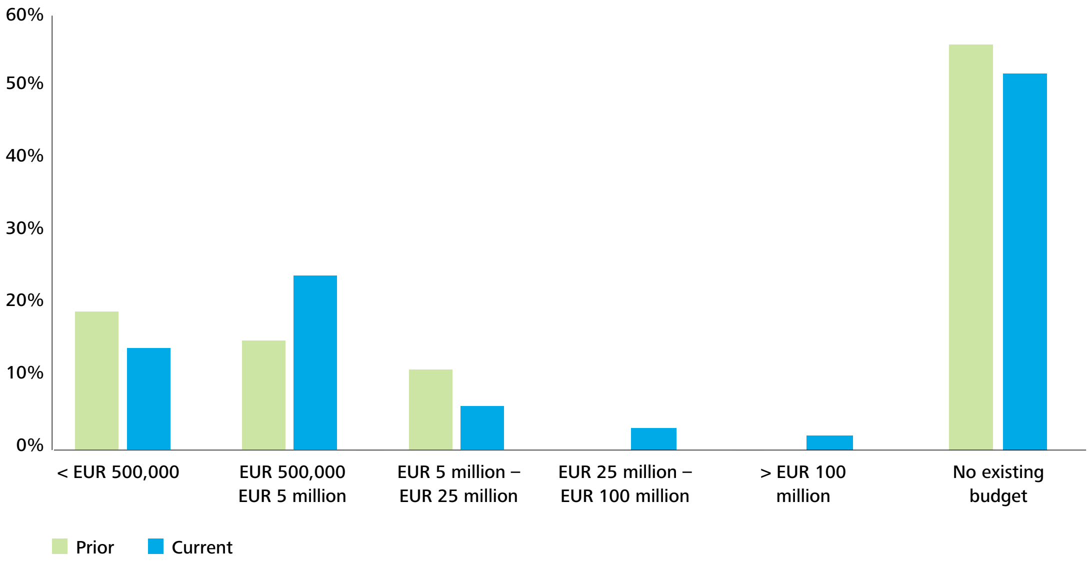
Most banks surveyed consider that two years would be sufficient time to implement the new requirements. The amount of time banks believe they need has reduced since they were last asked about this, when banks generally thought that three years would have been required to complete implementation of IFRS 9. This shift is consistent with recent deliberations by both Boards to utilise where possible existing credit risk information in determining impairment under their expected credit loss models. It is clear from the above graph that impairment is considered to need most time to implement, with a simple weighted average of 19 months for both classification and measurement and hedge accounting, compared to 23 months for impairment.

Figure 28. What do you estimate the total budget that you may require to meet IFRS 9 requirements to be?



Around half of the banks taking part in the survey do not have an existing budget for their IFRS 9 implementation. One of the reasons cited is the continuing uncertainty as to what the IASB's final requirements will be and the reluctance to incur expense on proposals that are moving. One bank which was in the €5-25M bracket has paused their implementation project for this reason. The high proportion of banks with no budget may also be because work will be performed by existing technical staff and the cost of their time has not specifically been budgeted for as part of IFRS implementation planning exercise. For those banks with budgets, the amount allocated to meeting IFRS 9 requirements has generally increased during the year; however a simple weighting of the data shows a drop in budget per bank of one third from €17m to €11m.

Figure 29. Do you have any existing budget for IFRS 9?



However, considering that 62% expect to start their IFRS 9 implementation project by the end of 2012 or early in 2013 (figure 25), it is perhaps surprising that half the banks surveyed still do not have an existing budget committed to this work. On the same weightings as before, those who have an existing budget have €5m set aside, less than half of the estimated final cost but more than double the previous budget of €2m. (This increase mostly reflects the impact of asking the question one year on rather than any great increase in estimated cost.)

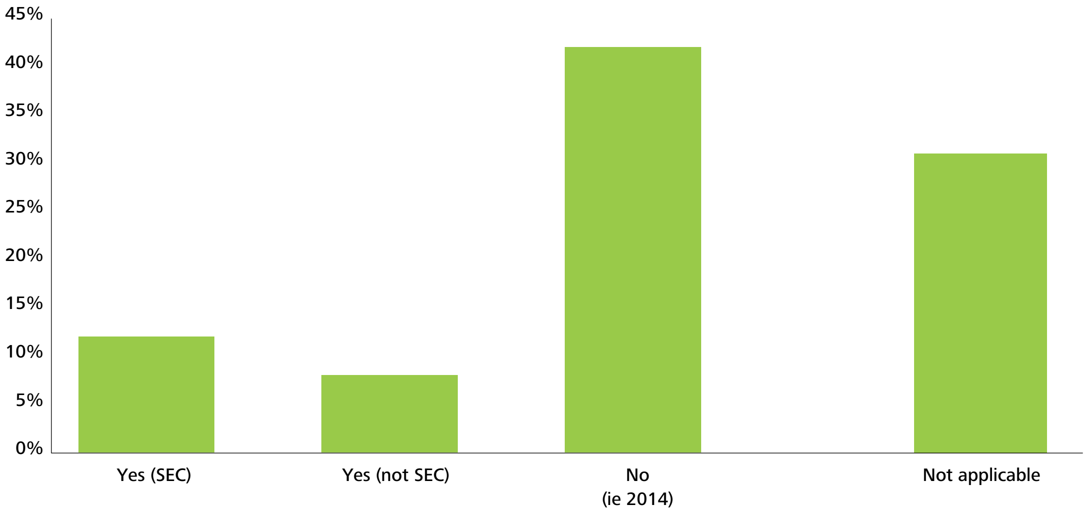
IFRSs 10 *Consolidated Financial Statements* and 12 *Disclosure of Interests in Other Entities*

With an IASB effective date of 1 January 2013, the implications of IFRS 10 are beginning to be more fully understood. Banks are assessing the effect of the consolidation or deconsolidation of entities on the size of the balance sheet, their capital requirements and income statement.

The IASB's effective date for the new consolidation and disclosure standards is for periods beginning on or after 1 January 2013. The exemption from consolidation contained in the new Investment Entities standard is for periods beginning on or after 1 January 2014 and, like IFRS 10 and 12, the Investment Entities standards permits early application. For those in the EU, it looks increasingly likely the effective date of IFRSs 10 and 12 will be a year later than the IASB's effective date, i.e. 1 January 2014, but also with early application permitted. Early application would ensure Foreign Private Issuers registered with the US SEC can continue to comply with IFRSs as issued by the IASB during 2013. Against this background, this year's survey asked banks to describe their plans.

The responses show that most EU banks would implement in line with the expected later effective date, giving themselves more time to implement the changes. Of those who would proceed earlier, most would do so because of the SEC requirement to file IFRS financial statements in accordance with IFRSs as issued by the IASB. Banks that expect to apply before 2014 currently expect their implementation work to be completed by the end of 2013.

Figure 30. For those banks that have their ultimate parent or major subsidiaries in the EU that are required to follow IFRS, do you expect to apply IFRS 10 and IFRS 12 in 2013 even though EFRAG has proposed to delay the mandatory effective date to 1 January 2014?



FASB position on consolidation
The FASB has started redeliberations related to the project and expects to issue final guidance in the first half of 2013. To date, the Board has not made any significant decisions related to this project, during the redeliberations process, since the ED and related comments.

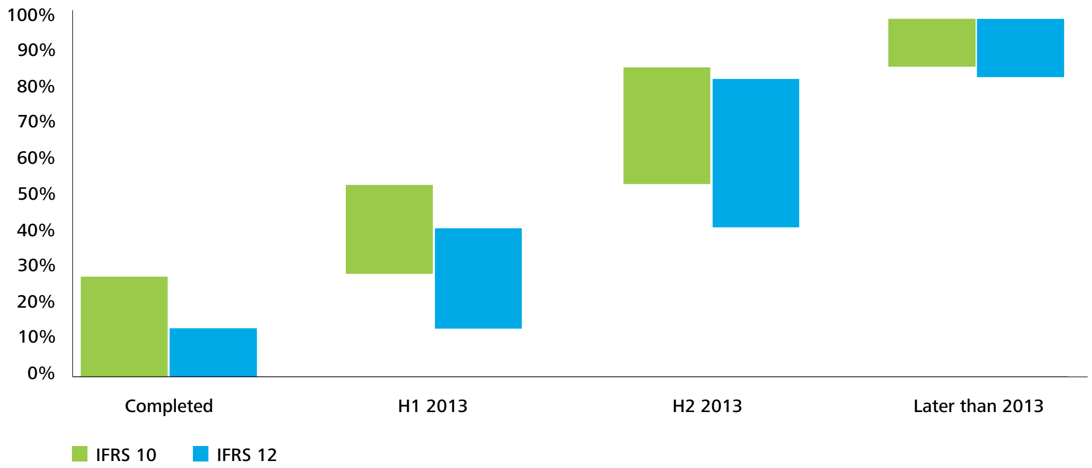
The FASB issued a proposed ASU that would provide guidance on assessing whether a decision maker is acting as a principal or an agent when performing a consolidation analysis. The proposal would amend the criteria for determining whether an entity is a variable interest entity (VIE) and, if so, whether a reporting entity is the VIE's primary beneficiary. The proposal would also revise the definitions of participating and kick-out rights, and amend the evaluation of limited partnerships for consolidation.

The Board received 60 comment letters from various respondents – primarily from financial institutions. While most respondents agreed with the qualitative assessment in the proposed ASU for analysing whether a decision maker is a principal or an agent, some were concerned that the proposed qualitative assessment could result in inconsistent and incomparable consolidation conclusions. Respondents also generally agreed with the three factors in the proposal to consider in performing this assessment: 1) rights held by others, 2) fees paid to the decision maker, and 3) the decision maker's exposure to variability of returns from its other interests.

Some respondents also expressed concerns that the proposed ASU's implementation examples may be considered to create inappropriate "bright lines" for how to weigh each factor in the analysis and the level of economic interest that would result in consolidation.

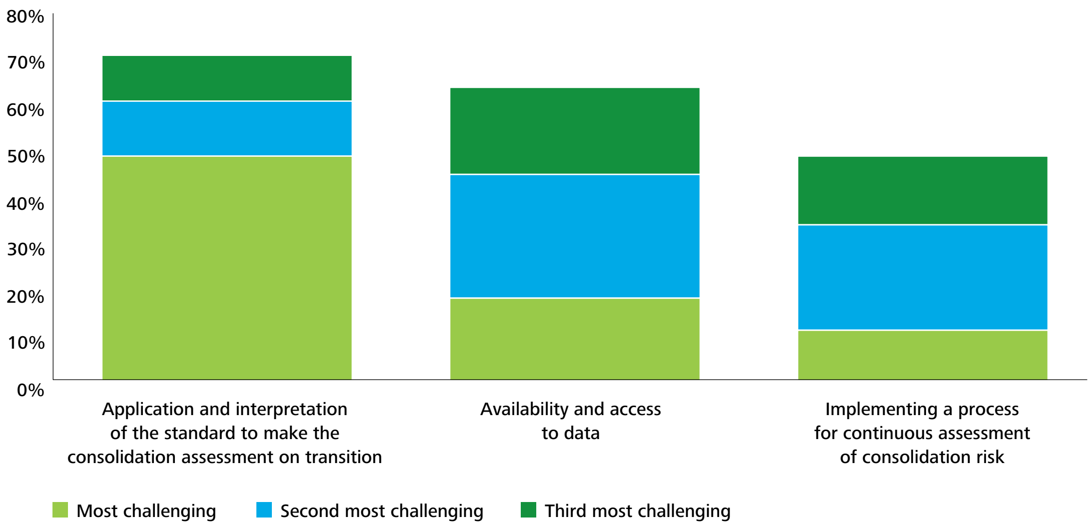
Views were also mixed on how rights held by other parties (participating and kick-out rights) should be considered in the principal-versus-agent analysis. In addition, respondents requested clarification on how interests held by the decision maker's related parties should be incorporated in the consolidation analysis, particularly in situations where the related parties are under common control.

Figure 31. When do you expect to complete your project to implement IFRS 10 and IFRS 12?



This year's survey indicates that whilst banks are making progress with implementing IFRS 10, the IFRS 12 work is generally lagging. The fact that many will not complete until the end of 2013 or later reflect the large number of European banks that took part in the survey, and their expectation that they will not need to implement until 1 January 2014. The banks planning to complete their implementation later than this include those in jurisdictions which will be moving to IFRS after 2013.

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



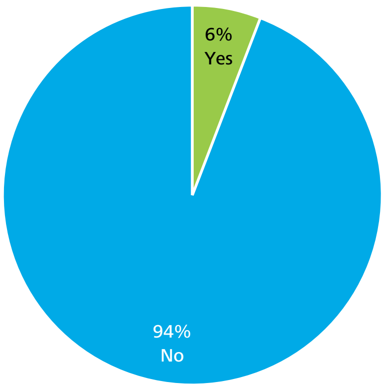
Like its predecessor IAS 27 Consolidated and Separate Financial Statements, IFRS 10 requires a control assessment that relies on judgement, but the definition and indicators of control are different. This has led to many Special Purpose Entity (SPE) structures being reassessed for consolidation purposes. The numbers of SPEs the world's largest banks need to review to implement IFRS 10 is significant, making this a major project.

Banks' assessments of substantive rights, relevant activities and variable returns are judgmental, particularly in relation to complex structures. Ensuring judgments are made consistently by different teams within a bank, as well as across the industry, explains why making the assessment on transition is regarded as the major challenge.

Many transactions and SPEs date back to previous periods, and for this reason data availability is also cited as one of the challenges for many. Banks need to value assets and liabilities in order to consolidate previously unconsolidated SPEs or calculate the retained interest on deconsolidation. This information may not be easily accessible and planning how to obtain it, and whether new processes are required, is a key implementation issue.

These results are consistent with last year's survey, where transition, data availability and process for continual assessment were noted as the three biggest challenges.

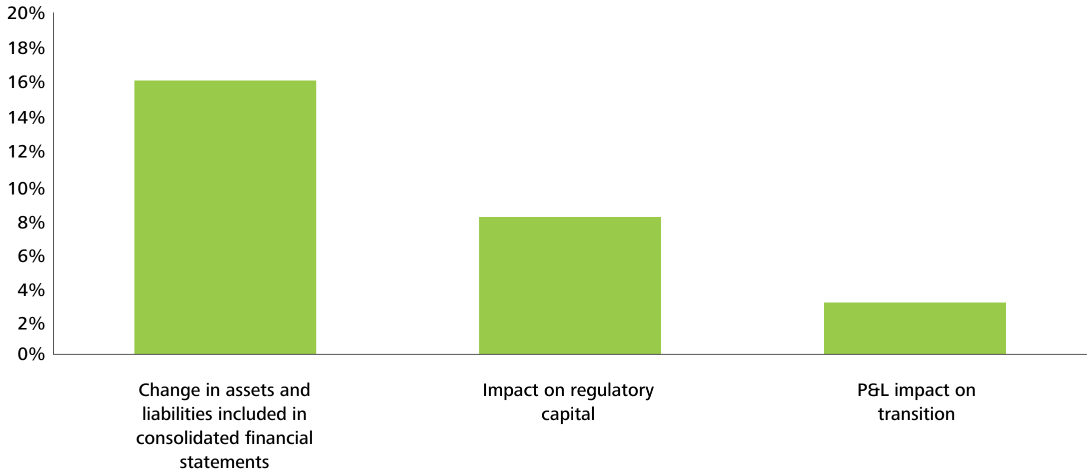
Figure 33. Are you considering or have you modified the terms of a significant number of existing transactions in response to the requirements of IFRS 10?



Apart from a small minority, banks are not changing the terms of existing transactions in response to the requirements of IFRS 10. The small number of banks that are making changes include those that, in the process of assessing control structures, have found that the relationship between them and an SPE could be set out more clearly. Banks are also clarifying the terms of partnership and other arrangements as part of their consolidation review.

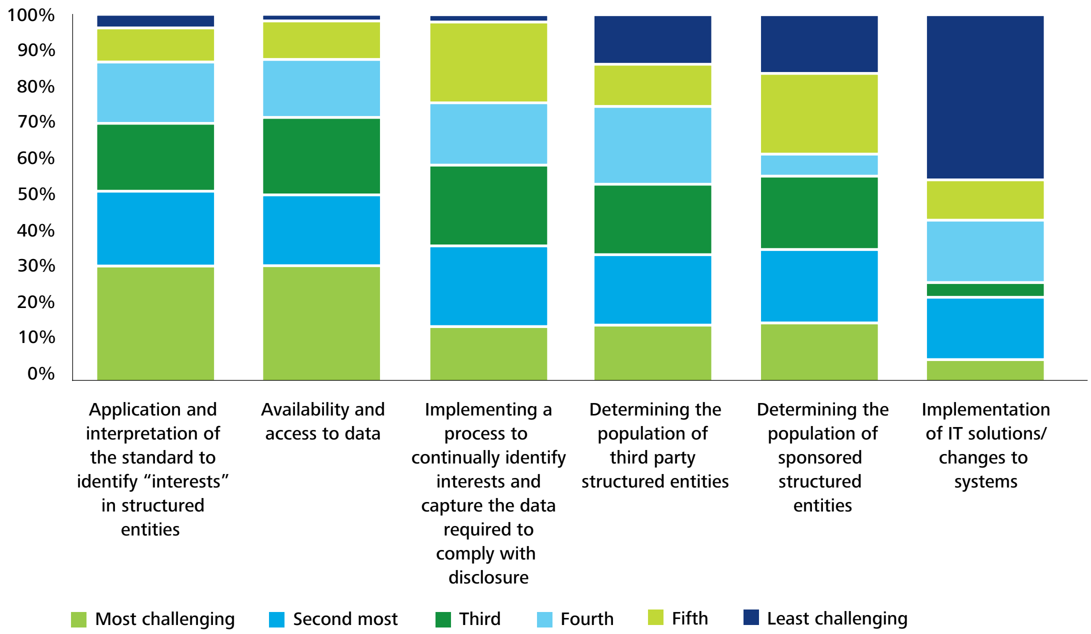
Consolidation changes have been seen in both directions, and will affect banks' balance sheets, income statements and regulatory capital calculations. In particular, Risk Weighted Assets will change as conduits, funds and other vehicles are consolidated or deconsolidated.

Figure 34. To what extent do you expect the following to apply to your organisation on transition to IFRS 10?



The main implementation challenges for IFRS 12 are similar in nature to those for IFRS 10. Application and interpretation of the standard to identify interests in structured entities is the most difficult task, and access to data is again a fairly major concern. Determining the populations of third party and sponsored structured entities are less challenging than either of these. Banks appear to feel fairly confident about the ability of their IT systems to support IFRS 12, rating it 'least challenging' to a much greater extent than any other issue.

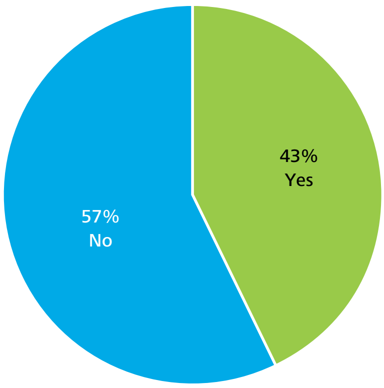
Figure 35. What will be the biggest challenge of implementing IFRS 12?



IFRS 13 *Fair Value Measurement* and Debit Valuation Adjustments

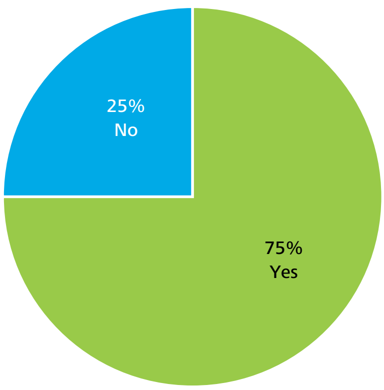
Debit Valuation Adjustments (DVAs), which take a bank's own credit risk into account in the fair value measurement of its liabilities, continues to be an area of interest for investors who want to understand the impact of these adjustments on valuations. The IASB have sought to clarify the inclusion of own credit risk, as part of non-performance risk, in liability fair valuation with the introduction of IFRS 13. This year's survey asked banks about their current DVA practices and whether they expect these practices to change on adoption of IFRS 13, which came into effect in January 2013.

Figure 36. Do you currently take into account Debit Valuation Adjustments in the valuation of OTC derivatives?



The question was put to banks before IFRS 13 came into effect, and responses indicated that most banks are not currently including DVAs when valuing their OTC derivatives, although a significant minority do. There were regional differences in the responses to this question, for example banks in North America typically included DVAs in the fair valuation of OTC derivatives more often than those in Europe. This may be reflective of the nature of collateral arrangements across regions, the materiality of DVAs in the context of the banks' OTC derivative portfolio and the existence of interpretations related to the concept of DVA within IAS 39. The IASB's clarification of DVAs in the context of 'non-performance risk' within IFRS 13 can be expected to harmonise the application of DVAs in fair valuing OTC derivatives.

Figure 37. Do you expect to take into account Debit Valuation Adjustments when adopting IFRS 13?



Based on the responses to this question, banks who are currently including DVAs in the fair value of OTC derivatives under IAS 39 will continue to do so under IFRS 13. In addition, an incremental banking population will newly measure DVAs on adoption of IFRS 13, which may be due in part to the IASB's clarification of DVAs in the context of "non-performance risk". All of those who replied no to this question also replied no to the previous question. These banks may be fully collateralised for their OTC derivatives and the DVAs under IFRS 13 may not be material.

US fair value measurement practices

In July 2012, the Deloitte member firm in the United States issued a Spotlight publication examining the first-quarter Form 10-Q filings of 30 financial services industry entities from the banking and securities, insurance, real estate, and asset management sectors. The objective was to understand how companies interpreted and applied the requirements of ASU 2011-04 on fair value measurement.

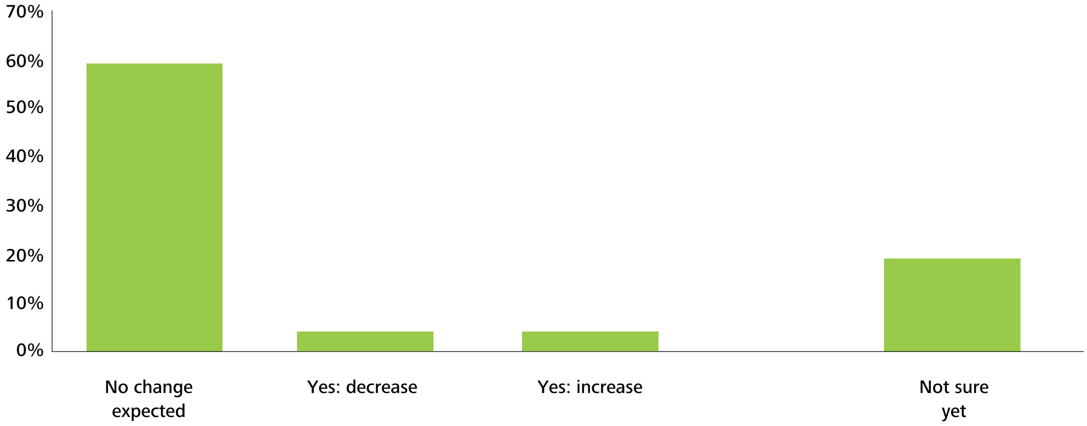
Most companies from that sample disclosed that the adoption of the ASU did not materially affect their financial position or results of operations, indicating that the ASU had little effect on measurement practices. However, the ASU's amendments to the fair value disclosure requirements in US GAAP were more significant. Although some entities applied the new disclosure requirements similarly, the results showed diversity in practice.

In addition to the observations contained in the report, the SEC staff has frequently requested registrants to provide additional disclosures about valuation methods and assumptions associated with fair value measurements, particularly those that rely on other observable inputs (Level 2) or unobservable data (Level 3).

Offsetting

The IASB in December 2011 issued amendments to IAS 32 Financial Instruments: Presentation to address inconsistencies that were arising in how the offsetting criteria were being applied. The IASB explained that some gross settlement systems, such as through a central clearing house, may be considered equivalent to net settlement. This is the case where the settlement method eliminates liquidity and credit risk and also processes receivables and payables together. The amendments, which are to be applied retrospectively, take effect for annual periods beginning on or after January 2014. Some banks have been working with clearing houses to establish how the settlement process will affect their accounting under IAS 32.

Figure 38. Do you expect to see a material change to the extent of offsetting of financial assets and financial liabilities as a result of the amendments to IAS 32 issued in 2011?



The IASB's amendments were broadly consistent with how many banks are already interpreting the standard, so the fact that most banks are not expecting to change is unsurprising. Only a few of the banks surveyed are expecting to see an increase or decrease in their use of offsetting as a result of the clarifications. As the changes do not take effect until January 2014, a quarter of participants in the survey have not yet established the impact of the IASB's amendments.

FASB and offsetting

The FASB issued a proposed ASU clarifying which instruments and transactions are subject to the ASU 2011-11 *Disclosures about offsetting assets and liabilities* requirements. Preparers had concerns that the scope of ASU 2011-11 is too broad and that the related compliance costs would exceed any benefits ultimately realised by financial statement users.

The FASB clarified the scope to be recognised derivatives, repos, and securities borrowing and lending transactions in accordance with either ASC 210-20-45 or ASC 815-10-45, or subject to an enforceable master netting agreement or similar (irrespective of the above guidance).

In explaining its rationale for narrowing the scope from all financial instruments and derivatives to those specified in the proposal, the Board noted that (1) constituent concerns about presentation differences between US GAAP and IFRSs focused predominantly on derivatives, repurchase and reverse repurchase agreements, and securities lending and borrowing arrangements and (2) it does not believe that, in practice, there are significant US GAAP–IFRS presentation differences for trade receivables and payables or unsettled regular-way trades.

Conclusion

Relative to the FASB's approach there is a preference among banks for the IASB's expected loss model for impairment and also that if the IASB's proposed approach was implemented it would result in an increase in provisions compared with the current requirements applied in IAS 39. However, most banks have put their programmes to implement financial instruments accounting change on hold whilst the requirements continue to be debated and developed.

This year's report shows that debit valuation adjustments will be adopted by a wider range of banks following changes to IFRS 13, harmonising practices around the world. Accounting for liquidity portfolios is also set to change, with most banks believing the proposed 'fair value through other comprehensive income' category for debt instruments will capture such holdings. As a result of proposed accounting changes to debit valuation adjustments, impairment and liquidity portfolios and the regulatory approach to these numbers, banks expect their capital requirements to increase. A consequence of this is that there is a potential for changes in the pricing of lending across a range of portfolios.

Prospects for convergence between the IASB and FASB appear low in the eyes of banks as the two Boards have been seen to disagree on key issues – even though compromises have enabled them to find common ground on many topics in the past. Previous surveys have highlighted that global banks want convergence, yet banks are increasingly nervous as to whether convergence can be achieved. The call for convergence may become louder if the regulatory capital impact under Basel III of applying different accounting standards results in regulatory capital differences. It is not yet clear whether the repeated call from the G20 countries for the Boards to continue to seek a converged solution will result in one.

Along with the banking industry as a whole, we will continue to monitor developments in the financial instruments accounting project closely during 2013, and aim to keep you apprised of changes.

Related publications

- *2013 Banking Industry Outlook* (November 2012)
- *European Bank Deleveraging* (October 2012)
- *Evolving in Response to Global Re-Regulation* (December, 2011)
- IFRS in Focus, *Hedge Accounting Draft: A Closer Reflection of Risk Management* (September, 2012)
- A Closer Look, *Hedge Accounting with Financial Options and Structured Derivative*s (September, 2012) and *Assessing Hedge Effectiveness under IFRS 9* (November, 2012)
- L*ooking beyond the numbers: Review of banks' 2011 annual reports* (October, 2012)
- *Promoting stability: insights into new recommendations for banks' risk disclosures* (October, 2012)

List of acronyms

AFS	Available for Sale
ASC	Accounting Standards Codification
ASU	Accounting Standards Updates
CECL	Current Expected Credit Loss
DVA	Debit Valuation Adjustment
ED	Exposure Draft
EDTF	Enhanced Disclosure Task Force
EFRAG	European Financial Reporting Advisory Group
EIR	Effective Interest Rate
EMEA	Europe, Middle East and Africa
EU	European Union
FASB	Financial Accounting Standards Board
FSB	Financial Stability Board
FVTOCI	Fair Value through Other Comprehensive Income
FVTPL	Fair Value through Profit and Loss
GAAP	Generally Accepted Accounting Practice
G-SIFI	Global Systemically Important Financial Institution
IAS	International Accounting Standard
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standard
OCI	Other Comprehensive Income
OTC	Over the Counter
RWA	Risk Weighted Assets
SEC	Securities and Exchange Commission
SIC	Standing Interpretations Committee
SME	Small and Medium-sized Entities
SPE	Special Purpose Entity
VIE	Variable Interest Entity

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