Preparing for IFRS accounting changes

Crucial developments for banks: an update

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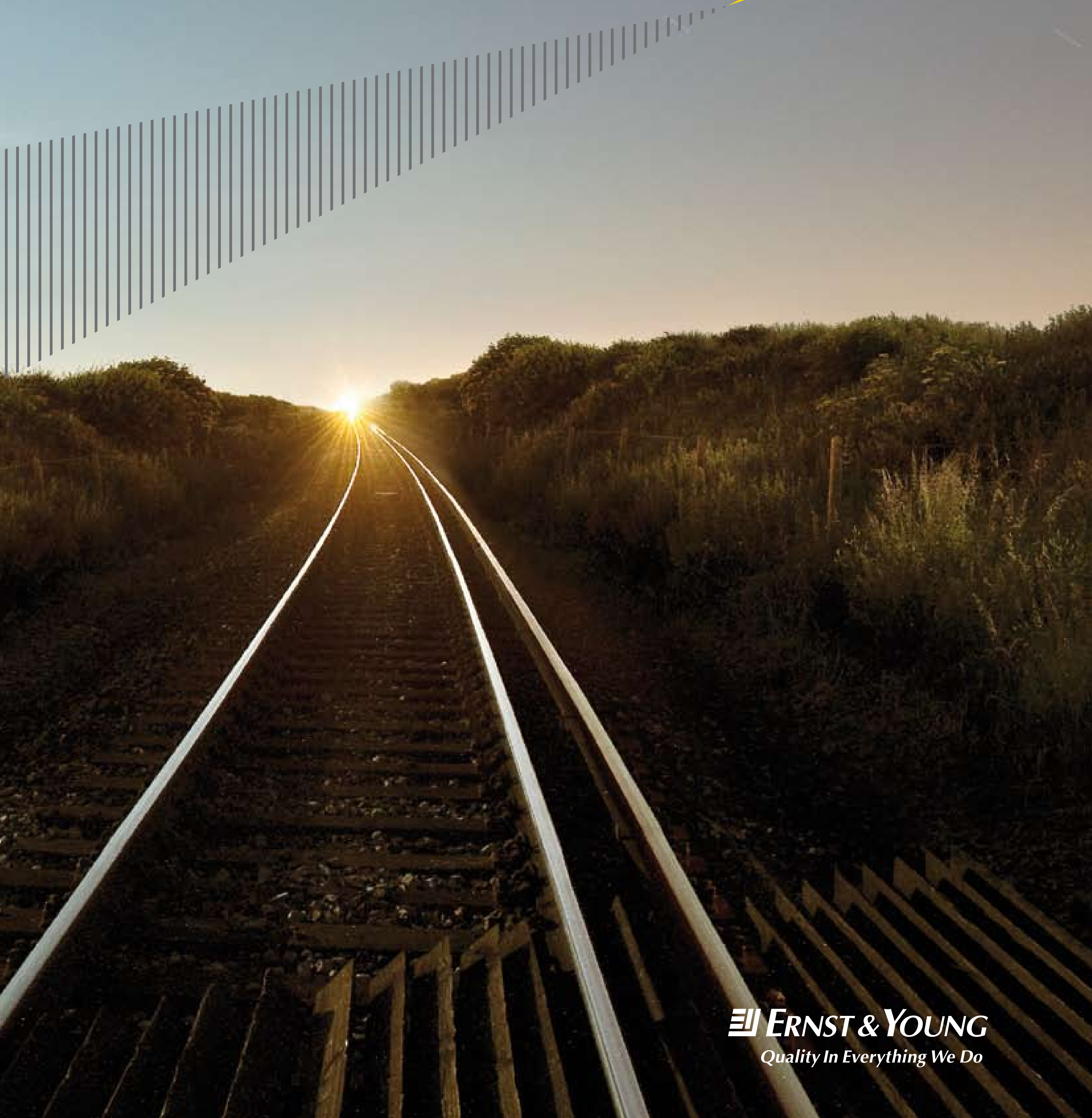

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Introduction

The International Accounting Standards Board (IASB) is continuing in its efforts to overhaul financial reporting — a number of new standards have been issued and others are expected to be finalized over the next few months. We highlighted the key accounting changes in the pipeline in our April 2011 publication *Preparing for IFRS accounting changes — Crucial developments for banks*. This paper updates the information in that publication.

The IASB's project to replace IAS 39 *Financial instruments: Recognition and Measurement* has been long under way. The new standard, *IFRS 9 Financial instruments* is being finalized in phases, the first phase on classification and measurement was completed in October 2010. The second phase, relating to the impairment of amortized cost financial assets, is the current hot topic and would potentially have a greater impact on banks than on any other industry. The third phase on hedge accounting, but without "macro" or portfolio hedging, is only expected to be finalized later in 2011. These changes, in addition to many other new standards will have a significant impact on the financial statements of banks in the future. Read our summary of the latest developments here.

Impairment of amortized cost financial assets

The history

In January 2011, the IASB, together with the US Financial Accounting Standards Board (FASB), published a Supplementary Document that included revised proposals for the application of an expected credit loss model. But the proposals did not receive overall support from constituents and the feedback was geographically split: constituents in the US generally preferred the FASB approach of recording a provision on the day a loan is granted, while constituents elsewhere generally preferred the IASB approach of allocating the credit loss over the life of the loan. That said, the key message was consistent – i.e., the Boards must aim to achieve a converged solution.

Current developments

The Boards have therefore decided to develop a variation of the previous proposals, taking into account the feedback from the Boards' original exposure drafts (EDs) and the Supplementary Document.

This variation would seek to reflect the general pattern of deterioration of the credit quality of loans. Similar to previously proposed models, the new impairment model would be based on expected credit losses and would determine expectations of future credit losses based on reasonable and supportable historical, current and forward looking information. Assets subject to impairment would be divided into three categories based on the level of credit deterioration:

1. The first category would be the general portfolio level of assets that do not meet the criteria for either of the other categories. In this category, the impairment allowance would be set at an amount equal to 12 months of expected losses, based on the initial expectations plus the full amount of any subsequent changes in lifetime expected credit losses.
2. The second category would consist of a group of assets that have been affected by the occurrence of an observable credit event that indicates possible future default, but the specific assets that will default cannot be specifically identified. The full lifetime expected credit losses would be recognized as an allowance, but the allowance would be calculated on a portfolio basis.
3. The third category would consist of assets for which there is information available that specifically identifies that credit losses have occurred, or are expected to occur, for individual assets. Similar to the second category, the third category would recognize the full lifetime expected credit losses as an allowance, but the allowance would be calculated on an individual asset basis.

How we see it

The new approach potentially raises certain challenges:

- The lifetime expected losses will need to be tracked vintage by vintage in order to capture and respond to subsequent changes. (Note that this was one of the main criticisms of the impairment model proposed by the IASB in its November 2009 ED).
- A two-fold calculation will be required for the good book (or category 1) – firstly, the 12 months expected losses, followed by the lifetime expected losses by vintage. (Note that this was perceived as a drawback to the approach proposed by the IASB in the Supplementary Document of January 2011).
- There should be an observable event that causes loans to be transferred between the proposed categories. Currently, IAS 39 requires certain trigger events to be considered in determining the collective provisioning for a portfolio of loans, although it is worth noting that there is diversity in the practical application of these requirements.

Therefore, the operational success of the new approach by the Board could potentially depend on: (i) refining the criteria/factors that trigger a transfer from category 1 to category 2; and (ii) banks being able to maintain vintage information.

Timing

It is expected that the Boards' new proposals will be published as a new ED in Q3 2011. The target date for finalization of the standard is not yet clear.

Example

The following example is based on IASB discussion papers and illustrates the application of the three-category approach:

Consider Bank Z whose entire portfolio consists of loans in Country X. This includes mortgage loans to individuals in Town ABC and Town XYZ. The national GDP in Country X decreases such that the general level of credit defaults for Bank Z's entire portfolio increases. This change of circumstances would be considered in the amount of expected losses estimated for the first category, but would not result in a transfer of loans to the second category where the entire lifetime expected losses would be recognized.

However, if housing prices in Town ABC decrease to such a level that defaults are expected to increase, all mortgage loans to borrowers in Town ABC would be transferred from category 1 to category 2 and the entire lifetime expected losses would be recognized immediately. This is because the declining house prices have a direct relationship to potential future defaults, but it is not clear yet which specific loans to borrowers in Town ABC are likely to default.

The result of transferring loans from category 1 to category 2 is potentially dramatic, with the recognition of all lifetime expected losses, compared to twelve month's losses for category 1.

Hedge accounting

The history

The IASB proposes to substantially simplify hedge accounting, by better aligning the accounting for hedging activities with risk management practices. The ED issued in December 2010 sets out the basic hedge accounting model, while a separate ED for macro hedging is expected to be issued later in 2011. Hedging of risk components will be permitted for both financial and non-financial items, if these are separately identifiable and measurable. Derivatives, in combination with non-derivatives, will be permitted as eligible hedged items. However, the most significant change would be the removal of the 'bright line' test of 80% to 125% for hedge effectiveness testing, although ineffectiveness would still need to be measured and included in profit or loss when it occurs.

The comment period for the ED ended in March 2011 and the Board is currently re-deliberating certain aspects of its proposals to address feedback received from constituents.

Current developments:

- Instead of terms used in the ED such as "unbiased" result, "minimize ineffectiveness" and "accidental offset", the IASB decided to base the hedge effectiveness test on the actual quantities of the hedged item and the hedging instrument used in the hedge relationship. In addition, there must be an economic relationship between the hedged item and the hedging instrument, and the effect of credit risk must not dominate the value changes that result from that relationship.
- Another key change to the ED's proposals is that, after the inception of a hedging relationship, rebalancing would be **required** in response to changes in circumstances that affect the hedge ratio.
- The Board has also confirmed the ED's proposal that a hedge relationship may be discontinued only when it no longer meets the qualifying criteria. Voluntary discontinuation would be prohibited when the risk management strategy and objective remain unchanged.
- In a change to the ED's proposals, the Board would permit hedge accounting for equity investments measured at fair value through other comprehensive income (OCI) under IFRS 9. However, hedge accounting would not be allowed for other exposures that affect OCI, such as economic hedges of defined benefit obligations.
- The ED included proposals to change the accounting mechanics in respect of fair value hedge accounting. However, the negative feedback received has resulted in the Board deciding to retain the current accounting for fair value hedges under IAS 39.

Timing

The IASB will continue its re-deliberations over the next few months and the final standard is expected in Q4 2011.

Macro hedge accounting

Macro hedging, or portfolio hedging for interest rate risk, was not included in the ED on hedge accounting. The EU created a 'carve-out' in 2005 from certain aspects of the IAS 39 hedge accounting rules to ease hedge accounting. The following aspects were carved out: hedges of prepayment risk in macro fair value hedges; hedges where the hedged risk is lower than that represented in the hedging instrument (also known as the sub-libor issue); and the ability to apply fair value hedge accounting to demand deposits. It is expected that the IASB will attempt to address these issues when discussing macro hedge accounting. However, it is not yet clear whether the new proposals will have the same broad effect as the EU carve-out.

Timing

The IASB is currently reaching out to banks to understand their risk management strategies. Based on the outcome of these discussions, the Board will decide whether to develop a completely new macro hedge accounting model or to modify the existing macro hedge accounting model in IAS 39. The IASB plans to issue an ED in Q4 2011.

Offsetting

The history

The recent joint IASB/US FASB ED *Offsetting Financial Assets and Financial Liabilities* proposed removing the existing differences in the offsetting requirements under US GAAP and IFRS. These differences result in significantly larger balance sheet sizes for banks reporting under IFRS when compared to those reporting under US GAAP. The key difference is that balances relating to derivatives that are executed with the same counterparty under a master netting agreement may be offset under US GAAP, whereas under IFRS, there also has to be the ability and the expectation that they will be settled net. The comment letter period for the ED closed in April 2011.

For IFRS reporters, the proposals are similar to the offsetting requirements in *IAS 32 Financial Instruments: Presentation*, but contain certain differences.

1. Firstly, the proposals clarify that the right of set-off must be legally enforceable in all circumstances (i.e., in the normal course of business, as well as on the default, insolvency or bankruptcy of a counterparty).
2. Secondly, the realization of a financial asset and the settling of a financial liability are considered to be simultaneous only when they are settled at the same moment. At present, IAS 32 indicates that the operation of a clearing house is deemed to constitute simultaneous settlement and it is only "in other circumstances" that the realization/settlement has to occur at the same moment in order to meet the offset requirements. For this reason, under the proposals, it would be more difficult to offset balances when using a clearing house.
3. Thirdly, the proposals stipulated that an entity should not offset the collateral pledged or the obligation to return collateral against an associated financial instrument. Such collateral should be accounted for as a separate asset or liability. As a result, it is unclear under the proposals whether cash collateral (i.e., margin payments) exchanged in connection with over the counter derivatives and certain exchange traded derivatives, are available for set off in circumstances where the collateral will be used to settle the derivative cash flows and so meet the offset requirements.

Current developments

Following joint re-deliberations with the US FASB, the IASB has tentatively decided to proceed with the ED's proposals subject to possible modifications to deal with the second and third differences mentioned above. On the other hand, the US FASB has decided against proceeding with the proposals, thus retaining the current US GAAP requirements. Consequently, it is likely that the Boards will work together to determine common disclosures which will provide a reconciliation of the effect of the GAAP difference.

Effective Dates consultation

A key concern for banks is the effective dates for applying the new standards. In October 2010, both the IASB and the FASB issued a consultation document seeking views about the time and effort that would be required to implement the proposed new standards, including IFRS 9. The IASB is currently considering the responses, wherein a majority of its constituents favoured a mandatory effective date no earlier than 1 January 2015, provided that the final standards are issued in 2011. It is widely expected that the Board will extend the mandatory effective date for IFRS 9 from 1 January 2013 (as currently issued) to 1 January 2015, possibly through an agenda decision during Q3 2011.

Other new standards

Our IFRS Developments publications (formerly *Supplement to IFRS Outlook*) announce significant decisions made by the IASB on different IFRS topics. A selection of publications which could impact the industry are listed below. These publications are all available at www.ey.com/ifrs.

Group entities

In May 2011, the IASB issued IFRS 10 *Consolidated Financial Statements*, which represents a fundamental change to determining which companies are included in consolidated financial statements. IFRS 10 requires that consolidated financial statements include all controlled entities, as assessed using a single control model. This is a change from the current two-model approach that exists under IAS 27 and SIC-12. Banks will need to reassess which entities, especially structured entities, it controls under the new standard. Furthermore, entities that create structured entities in order to implement specific products offered by banks may be affected by these changes. The changes would not only result in reassessments of consolidation when the new standard is first implemented, but also continuous re-assessment as facts and circumstances change.

Meanwhile, the additional volume of disclosures about both consolidated and non consolidated entities set out in IFRS *12 Disclosures of Interests in Other Entities* will give rise to significant data challenges. Also, IFRS 10 is accompanied by a new standard, IFRS 11 *Joint Arrangements*, and all of these standards are mandatorily applicable from 1 January 2013. For more details, read our publication *IFRS Developments* Issue 1.

Fair value measurement

In May 2011, the Board also issued IFRS 13 *Fair Value Measurement*, which aims to achieve a consistent definition of fair value and common requirements for the measurement of, and disclosures about, fair values in IFRS and US GAAP. Whilst the new IFRS does not change **when** an entity is required or permitted to use fair value under IFRS, it does change **how** fair value is measured. The standard, which is mandatorily applicable from 1 January 2013, could affect the way banks determine the fair values of financial instruments and other items. It is now clear that, for liabilities, fair value measurement should reflect non performance risk. The fair value of a liability instrument is measured from the perspective of a market participant holding the identical instrument as an asset. This, for example, means that a bank should include a debit valuation adjustment when determining the fair value of a derivative liability. This standard will also result in additional disclosures in the notes to the financial statements. For more details, read our publication *IFRS Developments* Issue 2.

Pensions

In June 2011, the IASB published amendments to IAS 19 *Employee Benefits*. The changes, mandatorily applicable from 1 January 2013, include the removal of the option for deferred recognition of changes in pension plan assets and liabilities (known as the "corridor approach"). The result will be greater balance sheet volatility for those entities currently applying the corridor approach. In addition, these amendments will limit the changes in the net pension asset (liability) recognized in profit or loss to net interest income (expense) and service costs. Expected returns on plan assets will be replaced by a credit to income based on the corporate bond yield rate. For more details, read our publication *IFRS Developments* Issue 6.

Leases

The IASB (jointly with the FASB) has proposed a single model (the "right-of-use" model) for leases, instead of using two separate models for operating and finance leases as under IAS 17. This new approach would result in all leases being included in the statement of financial position of lessees, both as an asset and a liability, thus grossing up the balance sheet. Potentially, this could have a significant impact for the leasing businesses of banks as the potential impact on gearing ratios of lessees could result in other forms of financing being more attractive. It would also potentially have significant regulatory implications for banks as lessees. The Boards are currently re-deliberating certain aspects of the proposals and may decide to re-expose the updated proposal before finalizing the standard. For more details, read our publication *IFRS Developments,* Issue 3.

What is the business impact?

The IFRS changes will impact the business, systems and processes, as well as the investor communications, of banks. Entities will need to evaluate these implications and plan their responses. In addition, entities should consider the timing of the adoption of any new standards.

In parallel with assessing the impact of the IFRS changes, entities will need to consider the interaction between the accounting changes and wider regulatory and macro-economic challenges. These include:

- Basel III
- Markets in Financial Instruments Directive
- Dodd-Frank Act
- Foreign Account Tax Compliance Act (FATCA)
- Jurisdictional banking levies and taxes

Examples of some of the commercial, financial, regulatory and organizational challenges that exist for banks are:

- How to manage expectations and educate external stakeholders during the period of change
- Understanding the decisions made by their industry peers
- Product restructuring where current products and business models may no longer be viable for a bank or its counterparty
- How reclassifications will impact key ratios, regulatory capital and tax
- What improved systems capability and data will be required to meet the more onerous disclosure requirements
- Assessment of the increased operational risk caused by changes to systems and processes
- Organization-wide change management: increased competition for resources, systems, data and process alignment, and management of quality and cost

In order to make an informed assessment, entities will need to understand the significant accounting and operational business impacts. Some of the new or proposed standards, in particular, those relating to the classification, measurement and impairment of financial instruments, are less rules-based. As such, management will need to exercise considerable judgement in implementing the changes to IFRS.

How can Ernst & Young help?

Ernst & Young can bring its multi-disciplinary team of accounting, tax, systems, and IT professionals to your company to assist in assessing what the accounting changes mean to you. In the chart below, we outline issues and steps the company should consider related to accounting changes, and indicate how Ernst & Young may be able to help you from initial assessment through to adoption.

Issues and steps	How Ernst & Young can help
Gain a general understanding of the new or proposed accounting standards	▶ Design and deliver a training session for company personnel on the accounting implications of the new or proposed standards ▶ Share insights of IASB views, including interpretations
Perform a preliminary assessment of the impact of the proposal on the company's financial statements and regulatory capital	Advise and provide input into: ▶ Gathering necessary scoping information to implement the new or proposed standards ▶ Calculating the income statement impact of implementing the new or proposed standards ▶ Assessing impact on key financial ratios and performance measures ▶ Identifying shortfalls in available information to implement the new or proposed standards ▶ Assessing impact on regulatory capital ▶ For a non-audit client, Ernst & Young can provide support, through the use of an automated tool, to determine the characteristics of financial assets for IFRS 9 classification. This tool is able to run queries through large data sets and identify features to help determine fair value classification using information from external data vendors. The use of this tool can reduce the time needed to analyze instruments that would require fair value classification based on characteristics of the instrument. This automated approach is also available for use on contractually linked instruments. For audit clients, Ernst & Young can use the tool to evaluate assessments made independently by company management.
Benchmark the company against peers and others in the industry	▶ Provide observations of how others are approaching the new or proposed standards, problems they are identifying and solutions developed ▶ Assist in the evaluation of peers, competitors and industry disclosures and expected impact on the financial statements
Assess processes for data collection, internal controls, IT systems	▶ Provide observations and insights based on leading practices regarding ways the company could design its business processes, IT systems, and internal controls to capture information necessary to apply new or proposed standards ▶ Provide criteria to consider in selecting IT packages, and assist in the selection process
Assess tax positions relating to the new or proposed accounting standards	▶ Assist in analyzing tax positions arising from adopting the new or proposed standards, reducing tax exposure, and determining tax effects of any accounting changes
Plan for ultimate implementation of the new or proposed standards	▶ Advise on the implementation of the new or proposed standards using an established methodology ▶ Advice regarding your project maintenance and planning, including timeline, tasks, and resource allocation
Advise management during the implementation	▶ Advise management where the new or proposed standards require careful use of judgment ▶ Review and provide input into accounting manuals and policies selected by management ▶ Provide coordinated support to you of the Ernst & Young subject matter resources (Regulatory, Tax, Finance Transformation, etc.) on a global basis
Communicate effect of implementation to stakeholders — analysts, regulators, shareholders	▶ Advise on developing a communication plan ▶ Advise on drafting communications

Contacts

EMEIA Financial Services FAAS Leader
Tara Kengla
+44 20 7951 3054
tkengla@uk.ey.com

EMEIA Financial Services IFRS Leader
Michiel van der Lof
+31 88 40 71030
michiel.van.der.lof@nl.ey.com

Country leaders

Belgium

Sylvie Goethals
+32 2 774 9518
sylvie.goethals@be.ey.com

Jean-Francois Hubin
+32 2 774 92 66
jean-francois.hubin@be.ey.com

Channel Islands

Chris Matthews
+44 1534 288 610
cmatthews@uk.ey.com

France

Amaury de La Bouillerie
+33 1 46 93 65 80
amaury.de.la.bouillerie@fr.ey.com

Laure Guegan
+33 1 46 93 63 58
laure.guegan@fr.ey.com

Germany

Edgar Loew
+49 6196 996 29011
edgar.loew@de.ey.com

Ireland

Vincent Bergin
+353 1 2212 516
vincent.bergin@ie.ey.com

Italy

Wassim Abou Said
+39 063 247 5506
wassim.abou-said@it.ey.com

Ambrogio Virgilio
+39 027 221 2510
ambrogio.virgilio@it.ey.com

Luxembourg

Aida Jerbi
+352 42 124 8614
aida.jerbi@lu.ey.com

Netherlands

Peter Laan
+31 88 40 71635
peter.laan@nl.ey.com

Spain

Manuel Martinez Pedraza
+34 91 572 7298
manuel.martinezpedraza@es.ey.com

Jose Carlos Hernandez Barrasus
+34 91 572 7291
josecarlos.hernandezbarrasus@es.ey.com

Switzerland

Stefan Schmid
+41 58 286 3416
stefan.schmid@ch.ey.com

John Alton
+41 58 286 4269
john.alton@ch.ey.com

United Kingdom

Sarah Williams
+44 20 7951 1703
swilliams10@uk.ey.com

Tony Clifford
+44 20 7951 2250
aclifford@uk.ey.com

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