The IASB's new impairment model

Views of European financial institutions
Definition of terms

The 2009 exposure draft (ED) – In November 2009, the IASB published a new ED on financial instruments carried at amortized cost, ED Financial Instruments: Amortized Cost and Impairment. The ED proposed that impairment of loans would be based on lifetime expected losses that would be built into the effective interest rate on a loan.

The good book/bad book proposal – The IASB and FASB published a joint document on 31 January 2011. The IASB considers this joint document, together with an IASB-only appendix (collectively, the supplementary document (SD)), to be supplementary to the ED Financial Instruments: Amortized Cost and Impairment that was published in November 2009. The SD proposed the loans should be recorded in either a good or bad book depending on credit quality.

The three-buckets approach – In July 2011 the IASB and FASB started deliberating a new model, where loans would be split into three buckets based on credit quality. This approach is the main topic of this publication.

Incurred but not reported (IBNR) – This is a provision currently applied under IAS 39 that reflects impairments relating to events which have occurred at the balance sheet date but are not yet captured by credit risk systems. This ensures that impairments that are incurred, but not yet identified, are adequately reflected in loan loss provisions.

Loss emergence period – The loss emergence period is a concept that recognizes that there is a certain period of time in between the emergence of impairment triggers and the time at which management becomes aware of the loss.

Watch list – The watch list concept is used by many financial institutions to raise risk awareness in the organization. Management places certain potentially problematic loans onto a watch list that typically results in closer monitoring.

Expert Advisory Panel (EAP) – This is a group of credit risk experts formed by the IASB in December 2009 to address some of the operational challenges of an expected cash flow approach.

Lifetime expected loss (LEL) – This is a measurement of the cash flows that an entity does not expect to receive on a loan over the full lifetime to maturity.

Migration cues – These are the trigger points or thresholds signalling when a loan, or group of loans, should move from one bucket to another.
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Introduction

The last few years have been among the most turbulent ever seen in the financial services industry. The credit crisis has highlighted the need to strengthen accounting recognition of loan loss provisions by incorporating a broader range of credit information than the current IAS 39 incurred loss model, and also recognizing losses at an earlier date, i.e., before they have been “incurred.” The current incurred loss model has been subject to much criticism because the significant divergence that occurs in practical application. This makes it difficult for users of the financial statements to compare entities. Finally, many constituents have called for further transparency in disclosures: both granular quantitative and qualitative information, which would be useful to the users of the financial statements.

Following the credit crisis, the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) (together, the Boards), proposed models for loan loss provisioning that were significantly different from each other. Many financial institutions urged the Boards to work together to achieve a common approach to loan loss provisioning to enhance comparability between IFRS and US GAAP reporters.

As a result, the Boards’ proposals have evolved from the publication of an initial exposure draft (ED) in November 2009, a further supplementary document (SD) issued in January 2011, and now to the expectation of a further ED during the second half of 2011. This ED will set out the proposals currently being developed by the Boards based on a “three-bucket” model for impairment provisions. These new proposals aim to take into account all of the concerns that were raised by constituents in response to previous proposals, and move the Boards to a final, converged model for impairment based on expected losses.
In simple terms, the proposals suggest that loans would migrate from bucket one to bucket two if evidence supports a deterioration in financial performance which leads to an increase in uncertainty about the ability to fully recover cash flows. Loans would migrate from bucket two to bucket three when there is a further deterioration of the financial performance of the borrower and expected non-recoverability of the cash flows. Loans in bucket one would carry a provision of 12 or 24 months expected losses. Loans in buckets two and three would carry provisions of full lifetime expected losses.

The Boards discussed distinguishing buckets two and three by the level at which the provision calculation is performed, with bucket two provisions being calculated at a portfolio level and bucket three provisions calculated at an individual loan level.

This survey of 10 major European financial institutions carried out by Ernst & Young in August 2011 provides a snapshot of current responses to the Boards’ current three-bucket proposals. We aimed to collate views to ascertain whether financial institutions see the proposals as a move in the right direction, consistent with internal credit risk management practices and operationally viable. We have also sought to identify whether the proposals would be expected to achieve the Boards’ goals of providing “more, earlier” and how organizations would expect to implement the proposals within their businesses.

We hope that you find the results interesting and insightful. Please contact us if you would like to further discuss the results contained in this report.
Executive summary

Respondents to this survey are generally supportive of the three-bucket proposals as a step toward a final, single, converged impairment model. The institutions we talked to believe that the approach could be made operational and includes important simplifications compared with the previous proposals in the original ED and subsequent SD.

The responses to the questions in this survey highlight a number of important points and themes.

Alignment with internal credit risk management practices is important
Institutions support the proposals being aligned with how loans are managed in the credit risk functions in their organizations, but they are concerned that pursuing the “relative” approach will divorce accounting from credit risk management. The relative approach would require all loans to be recognized initially in bucket one, regardless of their credit quality and for deterioration to occur before migration to bucket two or three is recorded. Respondents are not only concerned about the complexity this would create, but also believe it would be a significant opportunity missed to align accounting with internal credit risk management processes. Certain respondents noted this could be addressed through a hybrid solution of an absolute approach with a relative overlay.

The transition to the new approach will lead to significant increases in provisions
Institutions believe that the proposed approach will certainly result in higher provisions being recorded earlier in the lifetime of loans. A number of institutions expect that accounting provisions will frequently exceed regulatory expected loss calculations, which would lead to reductions in the regulatory capital surplus over capital requirements under Basel III.
Institutions need to determine the criteria upon which loans migrate between buckets

Respondents were clear that, in order to align the impairment buckets to internal credit risk management, the Boards should not prescribe “bright lines” when loans should migrate between buckets. Institutions should determine the most appropriate migration cues according to their products, processes and credit risk profiles and disclose them in adequate detail to address comparability between organizations and inform users of financial statements. However, some respondents believe it would be helpful for application guidance in the new standard to incorporate appropriate language from regulatory and rating agency definitions of substandard and higher risk loans, as principled guidance for where bucket boundaries should be drawn.

The proposed approach could result in increased volatility in both income statement charges and regulatory capital

Institutions are concerned that if the point at which loans must enter the lifetime expected loss buckets is too early, this will create significant volatility in the income statement, as loans would often cure and return back to bucket one. Institutions are also concerned that this would lead to significant volatility in regulatory capital, which is likely to be pro-cyclical rather than counter-cyclical.

Institutions expressed various other views, including a unanimous preference for 12 months of expected losses in bucket one rather than 24 months. Most institutions said that loans should be recorded in bucket two or three on initial recognition if that reflected their credit risk status at that time, but others felt that there should be some deterioration in credit risk before migration into buckets two or three, even though that would create additional administrative burdens. On one hand, some respondents also felt that buckets should be defined by credit risk measures rather than the level at which the provision calculation is performed, and on that basis, there was no need for three buckets, as two would deliver the desired outcome if supplemented with adequate disclosure of the credit risk profiles of loans in buckets one and two. On the other hand, some institutions felt that retaining three buckets would add to the clarity of information presented to users, in particular, the magnitude of “bad” loans populating bucket three.
During August 2011, Ernst & Young invited 10 major European financial institutions to be surveyed on their views on the Boards’ “three-bucket” credit impairment approach, as described in the discussions held by the Boards up to the end of July. Although the size and primary geographical business location of the participants varied, all of them have significant banking operations or are primarily banking institutions.

All respondents told us that the three-bucket credit impairment approach will have a significant impact on the level of provisions held. Some organizations also believe that provisions will often be greater-than-expected loss calculations used for capital adequacy tests and therefore will result in a reduction of the surplus of regulatory capital over required capital levels under Basel III. All respondents actively contributed to the Boards’ requests for views during the comment period on the 2009 ED and the January 2011 SD, which proposed a good book/bad book approach. The respondents were invited to participate in this survey because of their active participation in monitoring the progress of the impairment model, and all of them have analyzed the impacts of the proposed model on both the level of loan loss provisions and credit provisioning processes and systems.

We have selected certain questions from the survey that we believe are of most interest and, where applicable, the responses to questions or emerging trends from a current and future IFRS perspective. The survey results and our comments are summarized below, with graphs to illustrate the responses.

**Question 1: Would the institution prefer an allowance for bucket one based on 12 months or 24 months of expected losses?**

![Graph showing preferences between 12 months and 24 months for expected losses]

The Boards are currently considering whether to require either 12 months or 24 months of expected losses as the allowance for loans in bucket one. We asked our respondents which of these periods would be most appropriate for the impairment allowance on the healthiest bucket of loans and why.
All of the institutions surveyed indicated they would prefer the impairment allowance for bucket one to be based on 12 months of expected losses, although one institution commented that they still believe the time-proportional approach featured in the IASB’s supplementary document would be a preferred approach.

All respondents indicated requiring 12 months of expected credit losses for bucket one would align more closely with existing Basel II expected loss forecasts and other forecasting already performed within the company. Often these forecasts would be different, as they use through-the-cycle data rather than point-in-time estimates that would be required by the new accounting model. This would create a requirement for organizations to scale existing models or develop new point-in-time-based models for accounting provisions. Many institutions commented that the proposal to extend the allowance period to 24 months into the foreseeable future would simply lead to a higher “buffer” and a likely result in unwarranted income statement volatility.

The Boards are still discussing the impairment allowance for bucket one, so it is unclear at the time of publishing this document whether the allowance will be 12 months or 24 months, or possibly something else. As IASB members have previously commented, there is no principle behind either period. The Boards may also decide to change direction and explore one of their previous proposals for the impairment allowance in the good book based on a time-proportional amount of lifetime expected losses or changes in lifetime expected loss. Institutions we spoke to would generally be opposed to such a change in direction as there is a strong preference for a calculation that is simple, operational and has a degree of commonality with their existing regulatory calculations. The survey respondents were opposed to any calculation in bucket one that would be based on changes in lifetime expected losses because of the operational complexity in tracking changes.

Certain respondents with operations in the United States commented that there may be stronger support for 24 months’ expected losses in bucket one from US resident banks. If this is the case, then achieving a converged solution for impairment will continue to pose a significant challenge for the Boards.

All respondents see 12 months of expected losses as appropriate for bucket one.
Question 2: Would the institution prefer to keep buckets two and three separate or should they be merged?

The July Board meeting discussions for the three-bucket approach suggested that the impairment allowance for buckets two and three would be based on full lifetime expected losses, with bucket two being a portfolio-level calculation and bucket three being an individual loan-level calculation. Since the July Board meeting, various working parties including the EAP have suggested that distinguishing buckets by the level at which the calculation is performed should be replaced by distinguishing boundaries between buckets by absolute or relative measures of credit risk. This leads to the question of whether three separate buckets continue to be necessary, or whether buckets two and three should be merged.

Four institutions commented that they would like buckets two and three to remain separate, but five would prefer to merge them. One institution had yet to finalize its views.

One institution commented that it did not see any value in deviating from the bank’s traditional good book vs. bad book approach to managing loans by creating a third bucket. This institution felt that the addition of the third bucket, in this case bucket two, appeared artificial and would require a significant change in operations, including redesigning how the bank’s systems capture and report portfolio data.

Another institution that was also opposed to two buckets for bad loans found it difficult to reconcile two accounting concepts with three buckets. The institution felt that, if the only difference between bucket two and three is loans provisioned on a collective basis versus loans with specific provisions, then certain types of loans, for example retail loans, would never migrate to bucket three. This is because they are provisioned on a collective basis through to write-off and there is currently no credit risk process to split individual retail loans and migrate them to bucket three. The institution went on to suggest that if the Boards go ahead with the three-bucket approach, they would simply leave retail loans in bucket two so that the accounting treatment aligns with credit risk management practices.

Some institutions see merit in clearly distinguishing assets by credit quality in three buckets, although calculation methods may be similar in each bucket.

Other institutions commented that if the proposals were to continue to be based around three buckets, the definition of those buckets should be based on credit risk of loans, not the bucket’s calculation method. Collective or specific provision calculations could be used in both buckets two and three and would be dictated by how those loans are managed by the organization in those stages of the credit risk management cycle.
Some institutions commented that by following this approach based on credit risk of loans, there seemed to be little point in splitting loans with full lifetime expected loss provisions into two buckets and the relative volumes of loans at various credit risk stages within the bucket could instead be set out in supplementary disclosures.

However, three other organizations noted that they believe it is important to articulate clearly to users of their financial statements the distinction between impaired loans in bucket three and less risky loans in bucket two. One institution expressed a desire to specifically use bucket three for loans with a 100% probability of default. Similar comments were expressed by other institutions that felt that although buckets two and three would be calculated using similar methodologies, it would still be important to highlight the distinction between the credit quality of assets in those buckets through full disclosures.

**Question 3: Is the institution supportive of using a “watch list” concept for defining which loans should be in bucket two?**

![Pie chart showing responses to Question 3]

Only two institutions generally support a watch list concept for bucket two. The remaining eight do not feel that this is a useful migration cue from bucket one to two.

One institution commented that it has implemented watch lists across the organization and their use is clearly set out in operational policies that link to how impairment is assessed. A different institution said they will explore how to introduce watch lists consistently and embed these across the organization. This would appear to be the exception to the norm and would still not address the barrier of consistency between organizations as to where the boundaries of watch lists are drawn. This would be a clear impediment to incorporating the concept of watch lists within the accounting standard.

The institutions that are less supportive of using watch lists to define the population of loans which should be in bucket two gave a number of reasons why the idea could be problematic. Many institutions commented that, while they use a watch list concept internally, this is only for certain portfolios, such as large corporate exposures. If the Boards decide that the watch list should be a migration cue for entry into bucket two, then watch list criteria would have to be created for all loans. This would not align with current credit risk management practices. These institutions also felt that use of watch lists as a migration cue would lead to a lack of comparability between institutions, as the use of watch lists is usually an internal policy and not employed consistently across institutions.

Watch lists are not used consistently enough to use as a principle within the accounting standard.
Another institution commented that the risk profile of a loan on the watch list could be very different depending on country practices. This institution believes that certain countries would add only problem loans with significant deterioration to a watch list, whereas others would add loans much earlier with less deterioration. This institution also noted that their watch list is designed to promote awareness of risk within the bank and was not created or intended to drive accounting provisions. There are a number of indicators that could lead to a loan being added to a watch list. Some of these indicators are non-financial and, in this institution's view, may not align with accounting principles and therefore impairment provisions.

Some institutions commented that they have noted inconsistency in the use of watch lists across their organizations for several years. One institution noted that following a recent acquisition, further inconsistency in the application of watch list concepts had been noted in the acquired organization compared to its own established practices. This emphasizes the existence of different applications of watch lists between peer organizations today.

**Question 4a:** Is the institution supportive of an absolute or relative risk approach for allocating loans to buckets?

An absolute approach would involve classifying amortized cost assets according to a measure of absolute risk, such as point-in-time probability of default (PD) or credit grading, regardless of where the loan was categorized on initial recognition. This could lead to some loans being recognized initially in bucket two or even bucket three, which would require recognition of full lifetime expected loss provisions on day one. A relative approach would involve tracking an asset's risk history and moving between buckets according to movements in credit risk measures. For example, credit risk would have to increase before a loan could be moved from bucket one to bucket two, regardless of whether lower risk loans were already present in bucket two.

Two institutions are supportive of a relative risk approach, but six institutions feel that an absolute approach would be important in aligning accounting provisions with internal credit risk management processes. Two institutions expressly supported a hybrid approach ahead of the relative approach, and one further institution that supports the relative approach sees a hybrid approach as the best way to successfully implement the proposals in practice.

Institutions that prefer the absolute approach believe that migration between buckets should be based on the borrowers' absolute credit quality. This is consistent with how credit risk is managed within their organizations, and many institutions commented that they do not have advanced systems to track credit quality over the lifetime of loans, which they believe would be required under a relative approach. It is not clear whether the relative approach would require entities to track credit quality for each period over the lifetime of loans, or perhaps only the relative movement since origination would need
to be calculated. However, even if this were the case, respondents said they would find it difficult to determine how those cumulative movements would lead to migration between buckets without resorting to an absolute threshold credit risk measure of which bucket a loan should be recorded in.

It is on this basis that certain respondents said they would support a hybrid solution of an absolute approach with a relative overlay. This would involve clear boundaries, thresholds or cues being set for when loans should migrate between buckets, and all loans would be recognized initially in the bucket that credit risk aligns to. Loans which are recognized initially in buckets two or three would be treated differently, and would carry 12 (or 24) months of expected loss provision, rather than full lifetime expected loss. Some deterioration would have to occur before loans migrated to full lifetime expected loss provisions in bucket two or three. How those cues should be set is addressed in Question 9 of this survey.

Several respondents noted that they see the ability to apply professional judgement to whether loans should be migrated between buckets as an important overlay factor if credit risk measures such as PDs or credit gradings have not yet reacted adequately to management’s expectations of deterioration. This was further emphasized in responses to Question 8b.

Credit risk managers see an absolute approach as the way forward. Informed accounting policy managers believe some deterioration must arise after initial recognition for migration out of bucket one to occur. A hybrid approach emerges as the way forward.

Certain respondents noted that if migrations between buckets were based on relative changes in a loan’s risk profile, then accounting provisions would not align with how risk is managed in practice. Loans that are forced into bucket one on initial recognition would most likely be quickly migrated in practice (perhaps even on day two) to their “natural” buckets to realign with credit risk management processes and data. One institution commented that if this were anticipated, then there would be little point in creating a principle based on the relative approach that would not be employed in practice. However, one institution that supported the relative approach believes this would be the only conceptual basis that could be adopted that would not overload provisions on initial recognition of loans.
Question 4b: Does the institution agree that all amortized cost assets should go into bucket one on initial recognition?

The Boards have proposed that all amortized cost assets would go into bucket one on initial recognition. This could lead to amortized cost assets originated at a higher level of risk or acquired loans being included in bucket one, while amortized cost assets with a similar level of absolute risk may be included in bucket two.

Four institutions believe that amortized cost assets should go into bucket one on initial recognition, whereas six institutions felt that it would be appropriate to include them directly in bucket two or three on initial recognition where those loans met the definition of those buckets.

Most institutions were not concerned about initially recognizing loans in buckets two or three. More debate is needed on how purchased loans would be affected, particularly in a large bank business combination.

If assets are recognized directly into bucket two on origination or acquisition, then they would take full lifetime expected losses on the asset on day one.

Some institutions commented that purchased loans are managed within credit risk systems according to their contractual terms and current delinquency status. Therefore, “forcing” these loans into bucket one on initial recognition when alignment with credit risk systems would allocate such loans into bucket two or three would create a complicated offline reconciliation between contractual data from systems, fair value recorded on acquisition and impairment provision calculations. This would seem entirely possible when considering the business combination of one bank by another; requiring all loans of the acquired bank to be recorded in bucket one would require a huge amount of effort to reconcile with that organization's credit risk data on an ongoing basis.

A counter-argument raised by one institution was that this process is not dissimilar to the process to track assets that are reclassified into loans and receivables under IAS 39. As these were transferred at fair value, with accumulated fair value movements frozen in the available-for-sale (AFS) reserve, they are constantly monitored for deterioration that would trigger recycling of the AFS reserve.

Two other institutions noted that the issue could be eased by grossing up the value of purchased loans on initial recognition to their contractual value and separately reporting lifetime expected loss adjustments included within the acquisition fair value. These fair value adjustments would then be naturally unwound through the effective interest rate if no deterioration and migration into buckets two or three occurred, or transferred to bucket two or three provisions when deterioration did occur.
Some institutions noted that while the concept of not recording full lifetime expected losses on day one is sound, for high-risk loans, a significant portion of lifetime expected losses would likely be recorded in a 12-month bucket one, as losses on such loans usually arise early in a loan’s life, particularly when considered on a portfolio basis. The institutions also noted that, for purchased loans, lifetime expected losses would already have been factored into the purchase price (i.e., fair value). So even if some purchased loans were recorded directly into bucket two, there should be little if any further provision required on initial recognition – although there is a possible risk of double-counting expected losses in both the assets’ fair value on initial recognition and within impairment provisions if the accounting requirements do not adequately deal with this issue.

**Question 4c: Should buckets two and three be defined by the measurement of credit risk, rather than the level at which the calculation is performed?**

The impairment allowance for amortized cost assets in buckets two and three is based on lifetime expected losses. However, the Boards proposed that the allowance for bucket two should be made at a portfolio level, whereas the allowance for bucket three should be for individual loans. Certain constituents have commented that they would prefer the migration from bucket two to three to be based on changes in credit risk metrics rather than the level at which the calculation is performed.

All of the respondents believe that buckets two and three should be defined by measurement of credit risk, and none believe that they should be defined by method of calculation.

Respondents believe that collective and individual calculation methods should be available to each bucket and would be driven by the type of loans in those buckets and the credit risk management techniques used to manage those loans. For example, lifetime expected loss calculations on a collective basis would be utilized in both buckets two and three for retail loans in some organizations. The distinction between the buckets would be based on the credit risk quality of the loans. In other instances, specific or individual loss forecasts may be used in each bucket, if that is how those loans are managed in practice.

One institution felt that method of calculation was not an appropriate differentiator for buckets two and three, as they do not currently have processes to split out certain loan types from the current collective calculation approach. Therefore, if this were to be required, significant effort would be needed to create wholly new models and processes purely for accounting purposes. These would be divorced from the actual credit risk management processes employed by the organization in practice.

All respondents agreed the buckets should be defined by measurement of credit risk.
Question 5: Does the institution anticipate that impairment provisions under IFRS 9 will be greater than Basel II one-year expected loss forecasts?

Nine institutions anticipate that the IFRS 9 impairment provisions will be greater than one-year expected loss under existing Basel II models most or all of the time, whereas none believe that they would always be less. One institution had yet to finalize its views on this question.

Basel II expected loss models use through-the-cycle data, and therefore, accounting models that use point-in-time data may result in greater provisions during a downturn. One institution noted that while the downturn calibrations within Basel II models would usually more than compensate for this difference, if entry into bucket two was relatively early in the delinquency life cycle, then initial estimates showed that the volume of loans recording lifetime expected loss provisions would frequently increase total provisions beyond those recorded for regulatory purposes. If bucket one covered 24 months of expected losses, then this would always be the result. This would result in a reduction of capital surplus under Basel III if the same 12-month expected loss models are used as under Basel II and consequently would increase volatility within capital. One institution told us that their quantitative analysis showed that impairment provisions under IFRS 9 would always be at least 25% higher than the one-year Basel II expected loss and could be significantly more.

A majority of banks expect accounting impairment provisions under IFRS 9 to be greater than 12-month expected loss forecasts used in regulatory capital models. This could lead to a reduction in regulatory capital surpluses under Basel III.

Some institutions felt that the effect would be less pronounced and only occasionally might accounting provisions exceed regulatory provisions. Interestingly, these were also institutions that felt that the transitional impact of the proposals would be less than for other organizations, because they were generally carrying greater provisions today.
Question 6: Are current IBNR provisions greater or less than the provisions expected under a 12-month allowance for bucket one?

No institutions told us that current IBNR provisions are greater than the 12-month allowance for bucket one, but five said that current IBNR is less than the anticipated bucket one allowance. One institution currently operates a 12 month IBNR period across its portfolios and four institutions did not use IBNR provisions in a comparable manner. This is principally because in these organizations, collective provisioning methods are used before impaired loans are individually identified, rather than IBNR “emergence period” concepts. These collective provisions are used to calculate provisions for certain groups of loans, including industry or geographical sector provisions.

Most institutions will see an increase in provisions as a result of current IBNR provisions being less than the 12 month period that bucket one will require.

There is significant diversity in practice with respect to IBNR loss emergence periods, both in terms of length and definition. These tend to vary by product type, with higher-risk and shorter-duration loans having shorter emergence periods than lower-risk, secured and longer-duration loans. Institutions indicated that very few products currently have IBNR emergence periods of 12 months or more within current provisioning models. This indicates that a move to a 12- or 24-month period of expected losses in bucket one would result in an increase when compared to current IBNR provisions. Two institutions noted that in their initial analysis, deploying the three-bucket approach would result in a broadly linear increase in provisions from their current IBNR emergence periods to a 12-month period in bucket one. For example, bucket one provisions would be four times current IBNR provisions for products with a three-month IBNR emergence period.

It is important to consider this question in tandem with Question 7. If entry into bucket two is felt to be later than the current point of movement from IBNR to “impaired,” then this may offset increases expected when comparing existing IBNR provisions to bucket one provisions. However, none of the institutions we spoke to have formed a view that entry into bucket two would actually be later.
Question 7: Would entry into bucket two be earlier or later than current definitions of impaired loans?

Eight institutions told us that they would expect bucket two to capture loans earlier than the current definition of impaired loans, although one institution noted that it would strongly lobby for the definition to be the same. Two institutions had yet to develop clear views, as their current collective provisioning practices may already capture loans which will be in bucket two. These institutions had not yet determined whether bucket two provisions, which will require full lifetime expected losses, will be greater or the same as current collective provisions.

Most institutions see bucket three matching the definition of impaired loans used in IAS 39 incurred loss models. Loans included in bucket two under IFRS 9 will therefore generate increases in provisions compared with IAS 39, as these would not previously have been captured and will require full lifetime expected loss provisions.

When we combine these responses with those in Question 6, we see that institutions generally expect provisions to increase, both as a result of increases in provisions when comparing current IBNR provisions to bucket one provisions and as a result of more loans being captured within buckets two and three than would be captured in current impairment calculations. In other words, the definition of impairment currently occurs later in the delinquency cycle than the expected entry point into bucket two. This also correlates with responses to Question 5 and expectations of accounting provisions being greater than regulatory provisions in some circumstances.

No institutions felt that the earlier entry to bucket two would lead to a significant offsetting reduction in bucket one provisions.

Some institutions noted that if entry to bucket two is too early, it will lead to a significant “cliff effect” as loans move from a relatively low 12-month expected loss provision in bucket one to full lifetime expected loss in bucket two. In a changing economic environment, this will lead to significant volatility in income statement charges as loans would frequently “cure” and move back into bucket two. To mitigate these effects, these institutions felt that entry into bucket two should be defined by organizations based on the credit risk profile by product and entry to bucket two should be at a point where the amount of provision in bucket one has already built up to a reasonable extent, thus reducing the “cliff effect” as far as possible.

One institution felt that entry into bucket two should be the same point as the definition of impaired loans today. This would minimize the “cliff effect” and resulting income
statement volatility. Further, the significant increase in bucket one provision compared to current IBNR provision would deliver the “more, earlier” goal that the Boards appear to be seeking.

**Question 8a:** For retail/consumer-type loans, would delinquency status be the most appropriate basis for migration cues between buckets?

Six institutions told us that they would expect delinquency status to be the most appropriate migration cue for low-value, high-volume homogenous loans such as retail or consumer loans, whereas one institution said that internal credit grading would be more appropriate, as this is available and reliable across their portfolios. One institution was undecided, and two other institutions preferred to use the risk measures used by management, which may vary by portfolio or product type. This could be delinquency status for one product type or another measure such as PD for a different product, depending on how those products are managed. For example, one of these institutions would use other measures and estimates for retail loans but would revert to delinquency status for consumer finance loans. These respondents also acknowledged that these various measures are not consistently available across all retail banking organizations or for all portfolios, particularly in smaller banks.

Respondents strongly agreed that delinquency status would be the most appropriate measure for use as migration cues between buckets. Some institutions noted that this would be the only possible measure, while other institutions commented that they may look to utilize internal behavioral scores, which are largely driven by delinquency status, but also incorporate other internal and external data.

A number of institutions commented that they felt that the number of days past due used as migration cues between buckets should be determined by individual organizations according to their product types and internal credit risk management practices and adequately disclosed. In some institutions that generally write low-risk loans, such as prime residential mortgages, 90 days past due is not considered impaired and over half of such loans would cure back to “current” status within a reasonably short time. Consequently, these institutions believe it would be most appropriate for such loans to remain within bucket one at 90 days past due. With other higher-risk products, such as unsecured personal loans, loans which are 90 days past due have a much higher risk of rolling to write-off and therefore would be expected to be in bucket two.

Retail banks believe that mapping delinquency status to buckets would be the best way to determine migration cues for retail loans.
Some institutions also noted that these types of retail loans, particularly unsecured loans, are only ever managed through a collective provisioning process in their organizations. Therefore, they would never be recorded in bucket three if this bucket is based on an individual assessment concept. This is consistent with responses noted to Questions 2 and 4c, in that these institutions do not necessarily see merit in having both buckets two and three and believe that if there are both buckets, these should be defined by credit risk measures and not calculation method. However, other institutions noted that retail loans would ultimately be provided for individually.

**Question 8b: For wholesale/commercial-type loans, would credit grading be the most appropriate basis for migration cues between buckets?**

Seven institutions told us that they would expect credit grading to be the most appropriate migration cue for high-value wholesale or commercial loans. One institution said that PD would be more appropriate for their organization, although this does map to an internal grading scale which would also be utilized. Two institutions have yet to form views as to what cues would be appropriate.

**Most institutions would utilize internal and external credit gradings as migration cues between buckets. Others would use PD, or are yet to decide.**

Several institutions commented that it was natural to use external credit gradings where these are available for loans. This provides an independent measure that is consistently available across markets and can be applied with a high degree of consistency by organizations. Many of these institutions emphasized that use of a judgmental overlay will be of great importance, as gradings can suffer from a lag effect and not always reflect all qualitative information that management is aware of. The ability to apply judgment to which bucket loans are classified in is therefore seen as critically important.

Respondents felt there is less consistency in how internal credit gradings are determined and exercised between organizations. Consequently, although these institutions believe that internal credit gradings structures are a suitable basis for migration cues between buckets as they clearly align with internal credit risk management practices, each organization would need to disclose its practices, grading structures and how these are applied to the impairment buckets in order for users of accounts to understand how gradings are applied and also to address comparability between organizations. Some institutions were very concerned that credit grading structures vary by product type and, as a result, disclosing each relevant grading process could add substantially to the volume of disclosures.
Certain institutions believe that other measures may be more appropriate for migration cues, or have yet to form a view as to what measures will align to portfolios in their organizations. One institution that has sophisticated credit risk management systems expects to use PDs as cues, as these are already subject to strong internal governance processes. This institution noted that it would not expect to incorporate loss given default (LGD) into the migration cues, as this is a measurement of loss not risk of default and therefore should not influence how relative deterioration in credit risk is measured.

**Question 9: Would the institution like to see “bright lines” for migration cues provided in application guidance, as applicable to different loan types?**

Two institutions told us they would like to see “bright lines” for migration cues in the application guidance of the final standard, and eight institutions said they would prefer that “bright lines” were not prescribed.

Responses to this question were consistent with responses to Questions 8a and 8b. Most institutions were clear that they believe migration cues should be determined by organizations according to their product types, credit risk profiles and internal credit risk management processes. Mandating bright lines, such as 60 days past due for retail loans to enter bucket two, or CCC+ credit grade for wholesale loans, would not be appropriate for many products. It would also be inappropriate to apply such hard and fast measures in jurisdictions where credit risk measures are significantly different, such as emerging markets.

Some institutions that do not want bright lines to be prescribed commented that it may be difficult for the Boards to articulate how this principles-based approach will be drafted into the final standard, but do believe that this can be achieved and should be pursued. We heard suggestions from some respondents that the Boards could identify credit grades where PDs have passed a generally recognized level of risk, such as 10%, and incorporate into the accounting standard’s application guidance language currently used in practice by regulators and rating agencies to define those grades. This would provide principled guidance as to where bucket definitions and boundaries should be drawn.

Institutions that did express a preference for “bright lines” in the application guidance believe that this would aid comparability among peer organizations. These institutions expressed concerns that a purely principles-based approach would lead to increased diversity in practice versus the current impairment model under IAS 39. One institution’s

Most institutions want principles not bright lines. The language used in regulators’ and rating agencies definitions of impaired and substandard loans could help direct where bucket boundaries should be drawn.
opposition to a purely principles-based approach was based on the fact that it believes that such an approach would be accompanied by an impractical level of disclosure on risk management practices and explanation around migration cues. This institution believes that disclosure requirements are fast becoming an issue and that, despite significant new disclosures, analysts would still have difficulty comparing institutions.

Question 10: Does the institution think the three-bucket approach could be operational and an improvement if sufficient, clear application guidance on migration cues was included?

All institutions told us that they believe the three-bucket approach could be operational, although one institution expressed a general lack of support for the proposals overall. All institutions commented that significant development of impairment models and operational processes would be necessary in order to successfully implement the requirements. The primary focus would be on developing processes to forecast lifetime expected losses on a point-in-time basis, as this is a significant move from current forecasting processes which typically do not look beyond 12 months and are usually based on through-the-cycle data (see Question 1). Other necessary developments would include modeling behavioral lives of loans in order to forecast the timing of expected losses, which will be necessary to identify which expected losses will occur in the next 12 (or 24) months. Significant time would also be required to identify, develop, test and implement appropriately reliable external forecasting data into new forward-looking impairment models. This will necessitate robust governance processes to deal with both the new model development and also the “business-as-usual” review and approval controls exercised by senior executive management.

All respondents believe the three-bucket approach can be implemented operationally, unlike the Boards’ previous proposals. Significant development of impairment models and processes will be required.
What could be in the Boards’ exposure draft?

Following the Boards’ SD in January 2011, it is possible that the forthcoming ED setting out the three-bucket proposals could be quite short in length. The ED may focus on establishing the concepts of the buckets, the basis for provisioning in each and articulation of principles as to when loans should be migrated between buckets. We see the key aspects that the IASB need to address in the proposed ED as:

- Determining whether the proposals should be based on three buckets or just two
- The definition of what a loss is, when it should be recognized and whether the loss includes current and future interest payments
- A question as to whether 12- or 24-months’ expected losses is most appropriate for bucket one
- Principles for migration between buckets, taking into account the risk of income statement volatility if entry into bucket two is early
- Application guidance on how to apply these migration principles
- Application to debt securities and loan commitments
- Draft disclosure requirements that set out the extent of disclosure of internal credit risk management processes and how these align to the impairment buckets

Many of the principles from the original November 2009 ED may be easily transposed to the updated proposals, such as requirements to use all available and reliable internal and external data when compiling lifetime expected loss forecasts. In this respect, the Boards have already established accepted principles in many areas and the focus of the new ED will be on the timing of recognition of lifetime expected loss forecasts, rather than re-establishing the basis of preparing those forecasts. This was the intended purpose of the January 2011 SD. The SD proposals were not pursued because of the relative complexity.

Progress to date with the three-bucket proposals is encouraging in that the Boards appear to share a single view of how to create workable principles and respondents to our survey have indicated that the market believes that the direction of the proposals is generally positive. The Boards appear to have finally created an opportunity to deliver a single converged expected loss-based approach for impairment and are well placed to progress this opportunity to a widely supported final accounting standard.
What to expect next from the IASB

The IASB’s work plan currently anticipates a further ED or a Review Draft in the third or fourth quarter of 2011. A Review Draft would involve the Board having a draft standard prepared and published for comment, with the intention that it is close to the form of the final accounting standard. The Board will make the decision in terms of their due process and will consider the significance of the changes in the proposals since the January 2011 SD.

The Board has not yet indicated a target date for a final IFRS in its work plan. At previous meetings, the Board has stated a goal of concluding this phase of IFRS 9 by the end of 2011. That goal no longer seems possible. A new ED would be expected to have up to a 90-day comment period. The Board would then require a period of time to consider comments received, redeliberate as appropriate and draft a final standard. It would therefore seem more likely to expect a final standard in the first quarter of 2012 at the earliest, if the Board does re-expose.
Conclusions

The institutions we surveyed are generally supportive of the Boards’ proposals and believe the three-bucket approach could be successfully implemented within their operations. In this respect, we believe the proposals can now be progressed to a final accounting standard within a reasonable timeframe in 2012.

The Boards have a number of challenges still to address, such as reconciling the operational objectives of credit risk managers who desire an absolute approach with the accounting principles of a relative approach. The hybrid approach suggested by some respondents may achieve this and solve the Boards’ concern about recognizing lifetime expected losses on day one for higher-risk loans. Such an approach would also not require tracking the credit quality and performance of loans throughout the asset’s life. This would avoid a significant operational challenge noted by respondents and the IASB.

It is clear that accounting for purchased loans needs further and more detailed development in order to avoid unintended consequences in future bank business combinations in particular. Again, we believe that the Boards can achieve this goal and that it needs to be addressed before the forthcoming ED is published.

The scale of impact from these proposals for banks is very significant. Not only will many operational challenges be faced, but shareholders’ equity is expected to be materially reduced by increases in impairment provisions upon adoption of IFRS 9. Respondents also anticipate regulatory capital surpluses to be affected under Basel III. We expect this will capture the attention of senior management and external stakeholders early, and therefore the Boards must work to finalize their proposals and allow institutions to begin implementing their solutions from a stable platform as soon as possible.
Institutions we have spoken to are clear that changes to accounting for impairment are likely to have a significant impact on their organizations. This extends beyond the impact on financial statements, disclosures and regulatory capital measures, into design and development of new impairment provisioning models based on forecast expected losses over the lifetime of loans. Successfully implementing this forward-looking loss forecasting requirement is the challenge institutions will face.

Ernst & Young has been working with a number of major institutions in assessing the financial, capital and operational impacts of the IASB's various impairment proposals. This includes using our bespoke impact calculation tools to give early directional guidance for the range of financial and capital impact.

Ernst & Young can bring its multidisciplinary team of accounting, tax, regulatory, systems and IT professionals to your company to assist in assessing what the impairment proposals of IFRS 9 mean to you and how to adopt them. In the table below, we outline issues and steps you should consider concerning the implementation of the impairment proposals of IFRS 9, and indicate how Ernst & Young may be able to help you from initial assessment through to adoption of the new accounting standard.

<table>
<thead>
<tr>
<th>Issues and steps</th>
<th>How Ernst &amp; Young may be able to help</th>
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<tr>
<td>Gain an initial understanding of the proposed accounting changes and how organizations are planning for change.</td>
<td>▶ Design and deliver a training and awareness session for company personnel on the accounting and risk implications of the impairment proposals. ▶ Share insights of IASB views, including interpretations.</td>
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<tr>
<td>Perform a preliminary assessment of the impact of the proposed accounting changes on the company's financial statements and regulatory capital.</td>
<td>▶ For non-audit clients, Ernst &amp; Young can provide support through the use of a bespoke impairment impact assessment tool, to quantify and analyze the initial directional impact of the accounting changes. For audit clients, Ernst &amp; Young can use the tool to evaluate assessments made independently by company management. ▶ Advise and provide input on: ▶ Gathering necessary scoping information and baseline data to develop and calculate detailed impact assessments. ▶ Assessing the impact on key financial ratios and performance measures. ▶ Assessing the impact on regulatory capital. ▶ Identifying shortfalls in available reliable data and information to successfully build and implement forward-looking expected loss forecasting capabilities.</td>
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<tr>
<td>Issues and steps</td>
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| Benchmark the company against peers and other industry participants.             | ▶ Provide observations of how others are approaching the new impairment proposals, problems being identified and solutions developed.  
▶ Assist in the evaluation of peers, competitors and industry disclosures and the expected impact on financial statements. |
| Assess existing processes for data availability, internal controls and IT systems capability. | ▶ Provide observations and insights on leading practices regarding ways the company could design its business process, IT systems and internal controls to capture information necessary to apply the new or proposed standard. |
| Build point-in-time lifetime expected loss forecasting capabilities, with necessary controls and governance. | ▶ Advise and provide input on:  
▶ Developing existing through-the-cycle expected loss models using scalar adjustments and refined data.  
▶ Leading forecasting and modeling governance processes and operational controls post-implementation. |
| Plan, design, develop and test new impairment models based on lifetime expected losses. | ▶ Advise and provide input on:  
▶ Designing new models based on portfolios and products and testing for compatibility with existing processes and systems.  
▶ Embedding new models within organizational processes using experience of multiple previous implementations. |
| Advise management during the implementation.                                     | ▶ Advise management where new standards will require careful use of judgement and detailed audit trails of evidence of decision-making.  
▶ Review and provide input into accounting and risk manuals and policies selected by management.  
▶ Provide coordinated support to you of Ernst & Young's subject matter resources (regulatory, tax, risk, etc.) on a global basis across your organization. |
| Communicate effect of implementation to stakeholders – analysts, regulators, shareholders. | ▶ Advise on developing a communication plan.  
▶ Advise on drafting communications. |
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Ernst & Young

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