Deloitte.

Fourth Global IFRS Banking Survey
Ready to land

June 2014

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Preface

We are delighted to welcome you to the *Fourth Global IFRS Banking Survey*, the culmination of several months' work by Deloitte.* Against a background of continuing regulatory and accounting change, we wanted to find out more about how banks are approaching the implementation of IFRS 9 *Financial Instruments* and the consequences of increased provisioning for regulatory capital planning. Uncertainty remains around the exact final form of the IASB's requirements, and more especially as to how regulators will respond to the changed accounting rules. In our daily interactions with banks, their regulators and investors, we have seen that expectations around risk management and disclosure are evolving rapidly. In this context, our global financial services industry group has collated the views of 54 major banks, to keep you informed of how the industry is responding to accounting and regulatory changes.

Mark Rhys

Our previous surveys have stimulated discussions with a range of key stakeholders. We hope this survey will once again provide you with insights into current thinking and help develop market consensus where appropriate, through supporting conversations amongst and between institutions, investors, regulators and standard setters.

Jean-Marc Mickeler

We are extremely grateful to all the institutions and individuals who have participated in this survey, and thank you warmly for your contributions. We hope you find this report valuable. If you wish to discuss any of the themes raised by our research, please do contact one of us or your usual Deloitte contact. We look forward to working with you as you implement IFRS 9.

Regards

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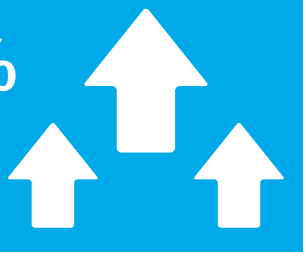
Key findings

Banks require 3 years implementation time
so may **come under pressure even with a 2018 effective date.**

Increasing expectations that banks' pricing
will be affected by accounting change.

2011 – 9%
2014 – 56%



Over half of banks surveyed believe that the expected loss approach will result in
banks' provisions increasing by up to

50%
across all loan asset classes.

70% of banks surveyed anticipate their IFRS 9 expected loss provision to be higher than current regulatory expected loss. However, capital planning uncertainty is set to continue as regulators' responses to changes are not yet known.

Co-ordinating
multi disciplinary
effort including finance, credit, risk and IT and resource constraints cited as the **key IFRS 9 implementation challenge.**

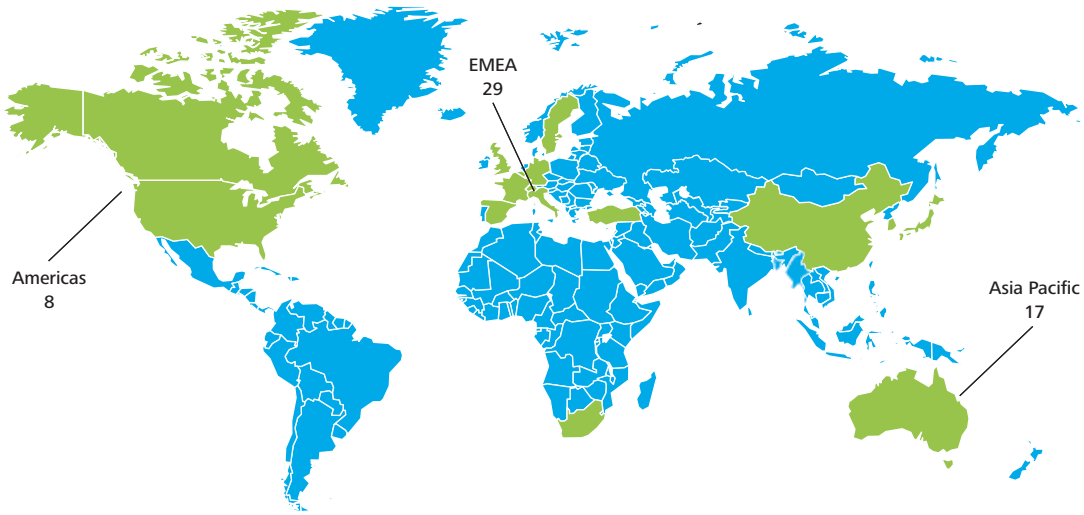
56% of banks surveyed are concerned about **credit data reconciliation and credit data quality.**

About this survey

This survey includes the views of 54 banks from Europe, the Middle East & Africa, Asia Pacific and the Americas. We received responses from 14 of the 29 global systemically important financial institutions (G-SIFIs) determined by the Financial Stability Board (FSB), including 11 of the 17 G-SIFIs who are International Financial Reporting Standard (IFRS) reporters. Altogether, 25 of the top 50 global banking groups measured by total assets listed in the *Banker Top 1000 World Banks 2013* took part. In most instances, responses have been coordinated 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 is the fourth time we have surveyed the world's major banks on IFRS 9 and related changes. Findings from our previous surveys were published in *IFRS 9 Impairment Survey 2011*, *Second Global IFRS Banking Survey – Q1 2012* and *Third Global IFRS Banking Survey*. Our growing dataset means we are now able to examine how views of accounting standards are changing over time. In the analysis that follows, we highlight the most interesting trends. In the charts in this report, we refer to the previous surveys in order of publication as the 1st, 2nd and 3rd respectively.

Figure 1. Geographical spread of respondents



Where are we now?

An outline of developments since our previous Global IFRS Banking Survey.

The International Accounting Standards Board (IASB) has pulled out the stops over the last year to drive forward its work on impairment, and is expected to publish its final requirements imminently. The final version of IFRS 9 will include the recently deliberated limited amendments to classification and measurement requirements and the forthcoming impairment requirements. This will be welcome news to many, as the G20's demands that financial instruments accounting be reformed were first articulated in the immediate wake of the financial downturn. The IASB will continue to work on macro hedging separately; a discussion paper was recently issued and comments are due by October 2014.

Based on the IASB's decisions and discussions to date, the final impairment proposals will – like the March 2013 Exposure Draft (ED) – be an expected loss (EL) model. Where there has not been a significant deterioration in credit risk since initial recognition, a provision for the credit losses expected to arise from default events in the next 12 months will be booked. Where there has been a significant deterioration in credit risk, the provision will be based on lifetime expected credit losses.

Given their significant differences on matters of principle, the IASB and Financial Accounting Standard Board (FASB) (together, "the Boards") have not been able to achieve a converged solution on either classification and measurement or impairment, the two areas of financial instruments accounting that the Boards had been working together on.

On classification and measurement, the Boards had initially pursued a converged approach which required that the classification and measurement of financial assets be determined on the basis of the assets' contractual cash flows characteristics (i.e., whether their contractual cash flows are solely payments of principal and interest under the so-called Solely Payments of Principal and Interest (SPPI) test) and the business model in which the assets are managed. In December 2013 and January 2014 respectively, the FASB decided not to proceed with both the SPPI test and the business model test whilst the IASB has retained both (albeit with some changes).

On impairment, whilst both Boards have been developing an expected loss impairment model, they have consistently differed on one fundamental point being the amount of provision to be recognized where there has not been a significant deterioration of credit risk (with 12 month expected losses preferred by the IASB versus lifetime expected losses from initial recognition preferred by the FASB). The IASB's impairment model is expected to be finalized in June this year as noted above and the FASB's impairment model is expected to be finalized shortly afterwards.

A further development is that the first suite of annual reports prepared since the Enhanced Disclosure Task Force's (EDTF) report, *Enhancing the Risk Disclosures of Banks* (October 2012), have been published. Banks have now had longer to reflect on and start to implement the recommendations. How disclosures are changing in response to the EDTF's work specifically and also as scrutiny continues from regulators, investors, politicians and the media, is discussed later in this report.

Reporting on our last survey results, we commented on the high level of interest by regulators, investors and politicians in the quality of banks' assets: this continues unabated. How impairment provisions have been calculated and how they should shape the amount of capital a bank holds are key concerns. In the Eurozone, the Single Supervisory Mechanism is being established, and high on the agenda for 2014 is a comprehensive Asset Quality Review (AQR) exercise by the European Central Bank (ECB) which is being followed by stress tests by the European Banking Authority (EBA). Across the European Union (EU), the importance of the AQR is increasing even for banks not supervised directly by the ECB. Non-Eurozone member states will also be part of the EBA stress tests. It is expected that the IT systems supporting credit loss data, the completeness of information on loans and corresponding provision decisions, and the sufficiency of impairment provisions will be within the scope of this work. Plans for stress tests are also being developed at the national level. How regulators across the world will respond to the changes in accounting requirements remains unclear, particularly as the IASB's impairment proposals have not been published in their final form. The potential impact of the changes on regulatory capital is one of the themes we explore.

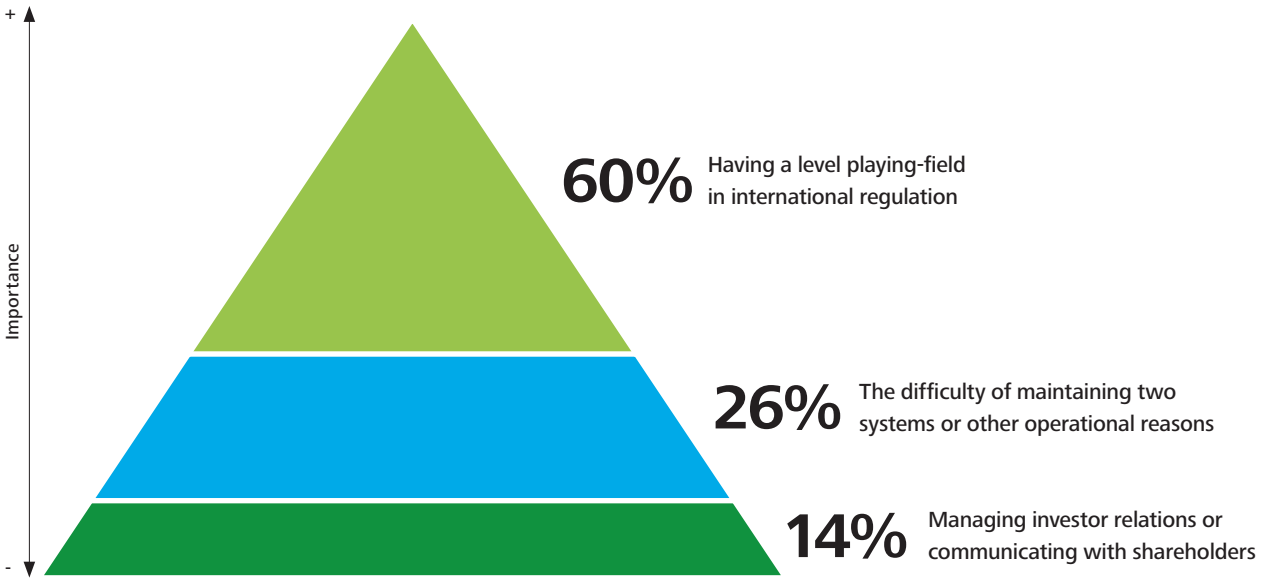
IFRS 9 accounting changes and capital impact

Convergence

As previously noted, the IASB and FASB have decided not to pursue convergence. Their differences on both classification and measurement and impairment have proven insurmountable.

Given the divergence between the Boards, it is unfortunate that the majority of banks (58 percent) consider substantial convergence between the IASB and FASB in financial instruments accounting to be important, against 42 percent for whom it is not. As we would expect, convergence is more consistently rated as important by the banks who report under IFRS and are registrants with the US Securities and Exchange Commission (SEC).

Figure 2. Why is convergence in financial instruments accounting 'very important' or 'good to have'?



The majority of banks (60 percent) that considered convergence as very important or good to have did so principally because it supports consistent regulation across the world. Operational considerations and communication with investors are secondary concerns.

We asked whether, in addition to recording and measuring credit losses in line with the IASB's proposed requirements, banks would consider also disclosing the expected lifetime losses that the FASB may require. Eighty percent of banks indicated that they do not think the benefits of disclosing lifetime expected losses would justify the additional effort. Calculating the Probability of Default (PD) and Loss Given Default (LGD) for lifetime expected losses would be a significant task for assets in 'stage 1' of the IASB model and given that the IASB's proposals would result in recognition of lifetime losses when credit risk deteriorates, banks see little value in calculating and disclosing this information ahead of such deterioration.

Awareness of accounting change

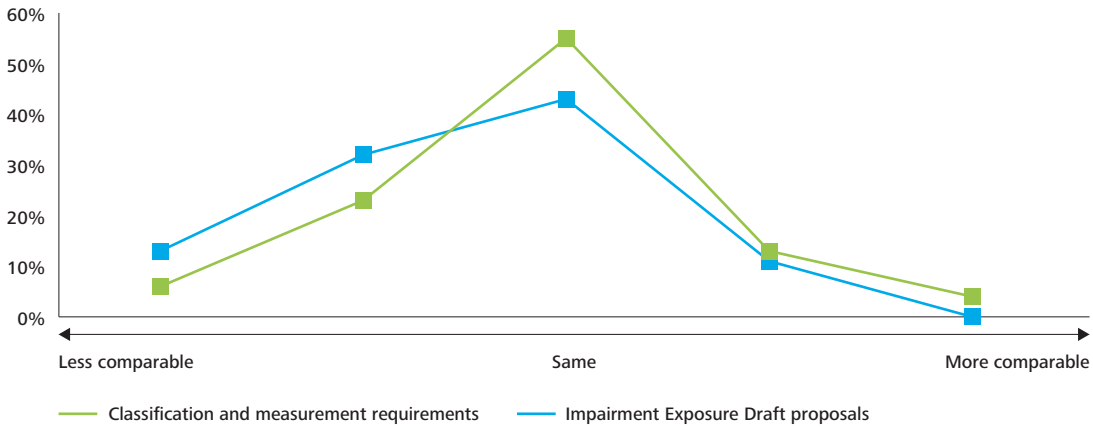
We asked participants to indicate the current level of awareness and involvement in IFRS 9 accounting changes at audit committee and board level. Despite regulatory interest in banks' provisions and the potential impact on capital of accounting changes around provisions, still 24 percent of boards are considered to have no awareness of the forthcoming change; these boards are perhaps finding that their agenda is driven by the continuing difficult economic environment and the raft of regulatory initiatives with which they now need to comply – rather than at a future date – so the unfinalized IASB proposals do not yet command their attention. The audit committee is typically keeping a closer watch on accounting changes than the board, with fewer audit committees having no awareness of the changes.

We also asked which topics boards have received briefings about. Boards are more likely to have an idea of the qualitative impact on their organization than a clear quantitative picture and are more likely to have received a presentation on the qualitative impact of impairment changes than on other accounting changes, illustrating the relative importance of impairment accounting. Classification and measurement and disclosure and reporting are the other areas on which banks are more likely to have received a presentation.

Using the new information

One of the objectives of financial reporting is to facilitate comparisons between businesses. We wanted to know whether banks think the proposed changes will make it easier or harder to draw comparisons.

Figure 3. Will financial statements users be better able to compare banks globally under IFRS 9 than under IAS 39?

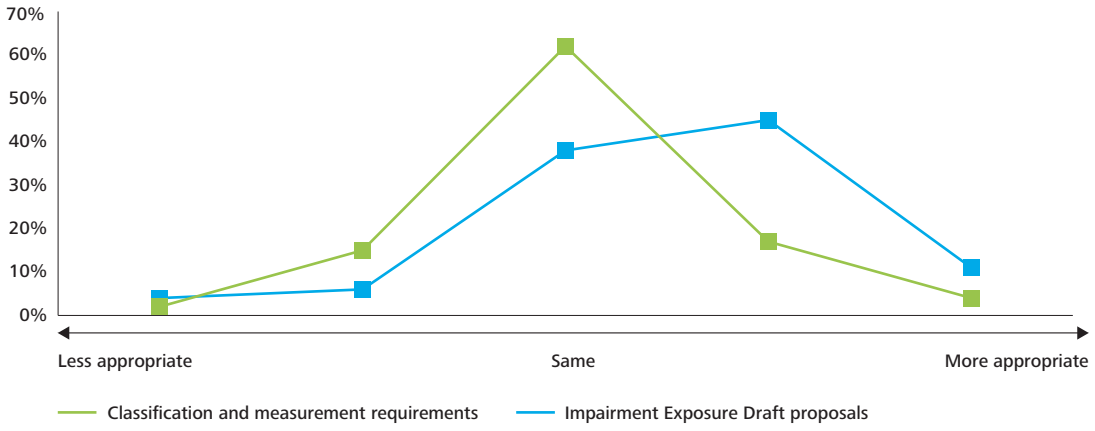


There is a significant minority of respondents, particularly in the case of impairment reforms (45 percent) that believe banks' financial statements will be less compatable under IFRS 9 compared with IAS 39. This view is driven by impairment measurement placing greater reliance on judgements of future credit events and recoveries compared with the current standard. The degree to which meaningful comparisons can be made will depend on the extent to which the industry provides similar disclosures.

By contrast, 55 percent think that classification and measurement changes will not affect comparability. Those who consider that comparability will reduce may have in mind the new focus on business models which the IASB's classification and measurement changes will introduce. This will make classification and measurement more entity-specific than it has been and correspondingly less readily comparable between banks.

If banks think that comparisons will be harder on a quantitative basis then the response by banks may be to enhance qualitative disclosures to bridge the gap.

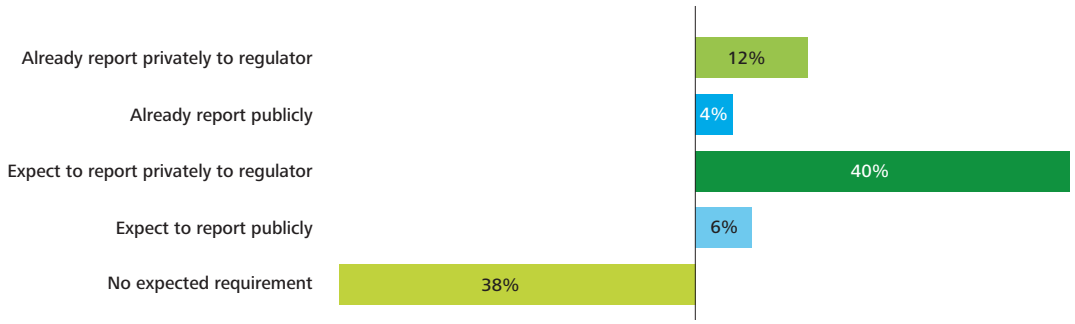
Figure 4. Do you think regulators will find IFRS 9 information more appropriate for supervision purposes than that prepared under IAS 39?



Ninety-four percent of participants think the IFRS 9 requirements will result in impairment information that is as appropriate or more appropriate for supervisors than that currently provided, and 83 percent consider classification and measurement information will be as appropriate or more so.

It is of note that a significant minority of banks believe under IFRS 9 their results will be less comparable with peers yet they believe this information will be at least if not more appropriate for supervision purposes.

Figure 5. Does your local regulator already request, or do you expect them to request, IFRS 9 or other forecast expected loss impairment estimates before the IASB's standard actually comes into effect in your jurisdiction?

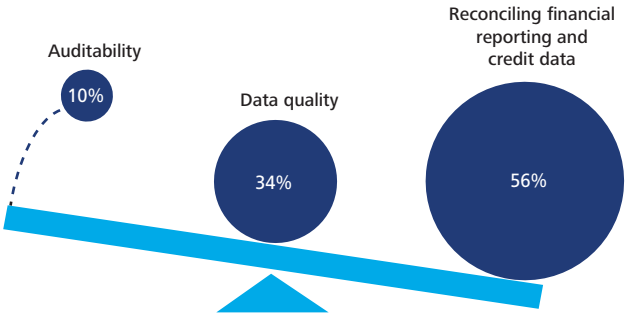


Sixty-two percent of banks already provide, or expect to have to provide expected loss information before the expected effective date for periods commencing on or after 1 January 2018. Responses reveal uncertainty around regulators' intentions, as we note that banks within the same countries have differing expectations as to whether they will be required to report this information publicly, privately or indeed at all. Banks' size did not determine when they expect to provide expected loss information: a number of G-SIFIs were amongst those to state that they did not expect to have to report expected loss information as a result of demands from their regulator.

Governance

Demands for transparency around credit risk are increasing, as awareness of the potential significance of this source of risk to banks has grown amongst investors and regulators. The October 2012 recommendations of the EDTF included five recommendations aimed at improving credit risk disclosure. Regulatory scrutiny is also driving change. This increased focus on credit risk means that banks are increasingly relying on credit risk information previously used only for internal purposes to support financial reporting requirements. However, a variety of legacy systems are typically found in many banks, and some information may be kept up to date in spreadsheets, where there may also be scope for errors. The sheer range of systems can also make it difficult to reconcile data extracted from different sources.

Figure 6. From a governance perspective, what are your biggest concerns about using credit risk management systems and data for financial reporting purposes?



… the ability to reconcile and the quality of credit risk data are key concerns for banks.

Banks' main concern in this area is data reconciliation, with data quality close behind. This reflects the close attention regulators are expected to be paying to banks' impairment data in the near future, including as part of the 2014 AQR in Europe. Given the legacy problems indicated above, the ability to reconcile and the quality of credit risk data are particular concerns for banks.

Interpretation

Banks have told us they expect and accept that their financial statements will be less comparable. The ease with which comparisons can be drawn will partly depend on how banks interpret key concepts in the standard, including 'low credit risk', 'significant deterioration' and 'default'.

Low credit risk

The IASB's impairment ED states that for financial instruments with 'low credit risk' at the reporting date, the entity would continue to recognize the 12 month expected credit loss. The ED goes on to provide an indicator of 'low credit risk', namely, where a loan has an internal credit risk rating equivalent to the external credit rating of 'investment grade'. The IASB's intention was to reduce the operational burden of tracking the credit risk for high quality investments, not to create a threshold test for significant deterioration. We were interested in finding out whether 'investment grade' provided an operationally useful shorthand and asked if banks have internal ratings that indicate 'investment grade' across their asset classes or products.

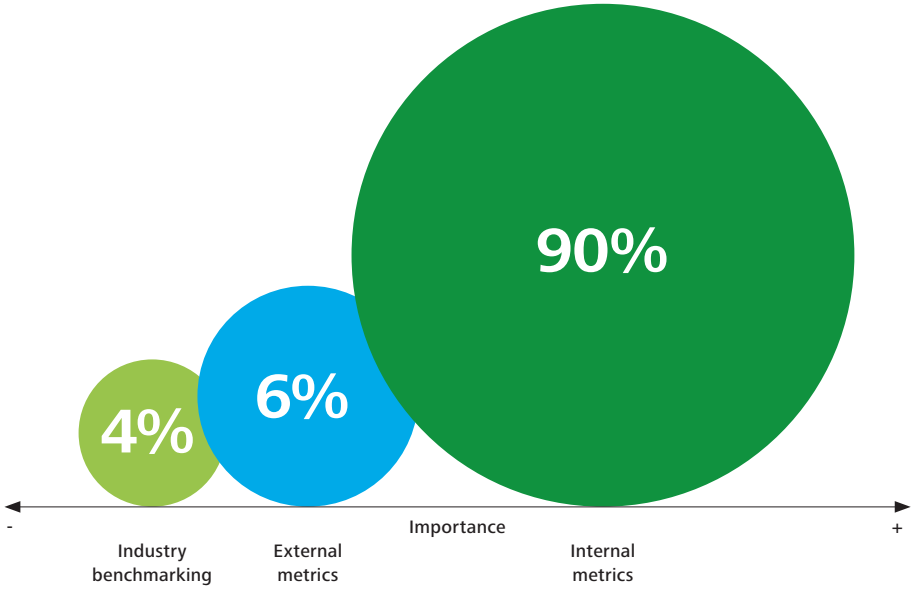
Banks have internal ratings that 'indicate investment' grade across most (60 percent) or all (22 percent) of their asset classes or products, indicating that a ready indicator of 'low credit risk' will generally be available.

Since we asked our question, the concept of 'investment grade' has become less significant. At the October 2013 meeting, the IASB tentatively decided to provide more guidance on the meaning of 'low credit risk'. At that meeting the IASB tentatively decided that 'low credit risk' should be described as:

- Having a low risk of default.
- In the near term, the borrower has a strong capacity to meet its obligation.
- In the longer term, the borrower's capacity may reduce but will not necessarily be reduced by adverse business or economic conditions.

The IASB also clarified that it did not intend all assets to be 'rated' – as long as they meet the requirements for 'low credit risk' they could be measured using the 12 month expected losses.

Figure 7. Where PD and LGD are used, how do you generally expect to approach data gathering?



Banks' proposed approach to data gathering where they use PD and LGDs will be primarily led by their existing internal metrics, as entities' own credit risk data will be the most important metric for 90 percent of banks.

When there has been significant deterioration in credit risk, the provision will need to be for lifetime expected losses. We wanted to find out what banks regard as key determinants of credit quality for the loans they hold, and how it varies between banks.

Figure 8. How do you expect to define and measure 'significant deterioration' in credit quality?

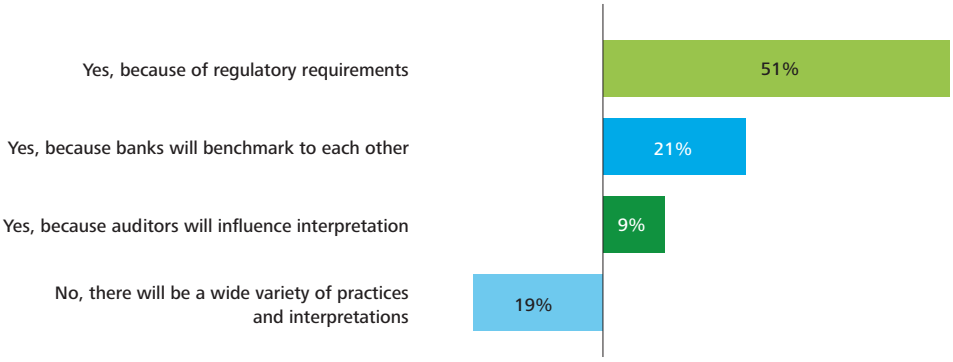
	Corporate	SME	Mortgage	Retail	Securities
One missed payment	14%	15%	30%	37%	8%
Change in PD since previous measurement exceeds trigger	41%	42%	19%	14%	40%
PD exceeds predefined trigger	31%	32%	26%	27%	30%
Modification (or forbearance) to terms not available in the market	10%	7%	7%	5%	3%
No market existing for loans today (and loans are not investment grade)	2%	2%	9%	7%	14%
Other	2%	2%	9%	10%	5%

For mortgages and retail loans, a significant majority of participants cited missed payments as the most likely measures to be used to identify significant deterioration whilst for securities, corporate and SME loans, the amount of movement or change in PD will be more important. PDs exceeding a predefined trigger was also cited by banks as an important measure across all portfolios.

Some banks are still considering what their approach to 'significant deterioration' for the purposes of IFRS 9 accounting will be. Regulators will prefer approaches that identify problems at an earlier stage, to 'rear window' approaches that identify significant deterioration only when payments are already late.

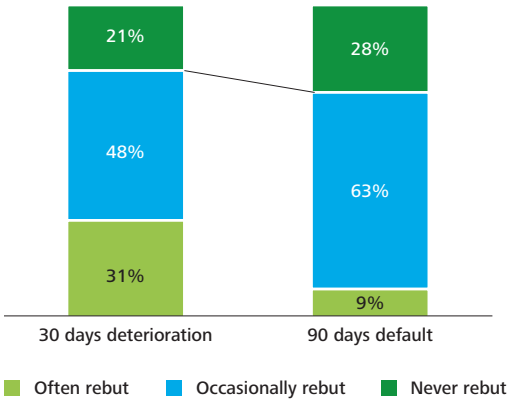
At the IASB's September 2013 meeting, it was agreed that a default definition that is consistent with an entity's credit risk management practices should be applied and that qualitative indicators of default should be considered.

Figure 9. Do you think banks will define default in a comparable manner?



Eighty-one percent of banks think that default will be defined in a comparable manner, with others expecting a variety of practices and interpretations. Regulators are expected to play a key part in the interpretation of this part of IFRS 9 – most of those who think default will be defined in a comparable way think consistency will be driven by regulatory requirements. Consistency is also likely to increase over time, for example benchmarking between banks will become easier as the volume of published information grows.

Figure 10. Do you expect to rebut the presumption that financial instruments have significantly deteriorated if they are overdue by 30 days or that default does not occur later than 90 days past due?



31 percent of participants expect to often rebut the presumption that loans overdue by 30 days have deteriorated significantly.

30 days deterioration

Thirty-one percent of participants expect to often rebut the presumption that loans overdue by 30 days have deteriorated significantly. This is a larger proportion than we had expected, given that the IASB developed its requirements with banks' existing practices in mind. It appears that many banks experience subsequent payments on overdue loans so are reluctant to adopt the IASB's criteria whole-heartedly given almost half of banks (48 percent) expect to rebut the presumption occasionally.

90 days default

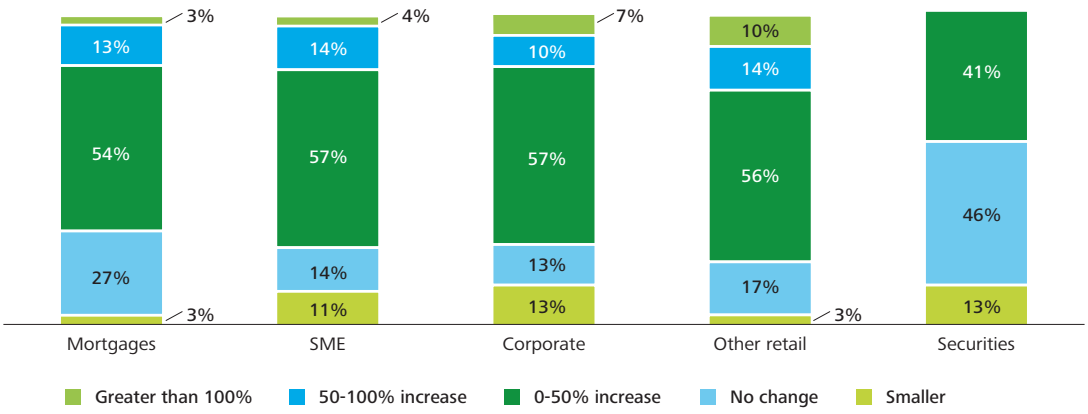
Banks are less likely to rebut the presumption that by 90 days past due a loan is in default, although 9 percent do still expect to do this often and 63 percent occasionally. The IASB and banks appear to be more closely aligned in their thinking here. Nevertheless, regulators may be dismayed by the 'bullish' tone of banks' responses to this question – as explained above, regulators are keen to see a move away from 'rear window' approaches and are likely to regard rebuttals of the presumption that a loan is in default when it is 90 days past due as falling into this category.

Discount rate

The IASB's impairment exposure draft allowed a choice of discount rates ranging from the risk-free rate to the original effective interest rate (EIR) for calculating the loss allowance. This was widely regarded as giving too much flexibility, without a clear rationale as to why this was appropriate. At the October 2013 meeting, the IASB decided to require that expected credit losses should be discounted at the effective interest rate or an approximation thereof. Our survey found that the majority of banks will take this in their stride, as two-thirds plan to use the effective interest rate, whilst the other third who had a preference for other rates will have to revise their plans.

How will impairment provisions change?

Figure 11. Assuming today's credit environment were to apply, how is your bank's total impairment provision likely to change on transition to IFRS 9?



Over half of banks expect an impairment provision increase of up to 50 percent across all asset classes excluding securities, with only a small proportion expecting an increase of more than 50 percent. For mortgages, this is particularly interesting considering the contrast with the results obtained by the IASB Fieldwork (detailed on the following page) which suggests that an increase of between 30 percent and 250 percent is expected in normal market conditions (this increases to between 80 percent and 400 percent when using downturn assumptions). The results of our survey are more in line with the results of the IASB Fieldwork for non-mortgage portfolios where the increase in impairment provision is expected to be between 25 percent and 60 percent. (This increases to between 50 percent and 150 percent when using downturn assumptions.)

IASB Fieldwork

Shortly after publishing its ED *Financial Instruments: Expected Credit Losses* the IASB invited 15 financial and non-financial firms to participate in fieldwork to test the proposals, including the directional impact on allowance balances, operational implementation challenges, and the responsiveness of the model compared to IAS 39.

- Mortgage sensitivity: The impact was estimated to be more significant for mortgage portfolios than any other portfolios covered by the fieldwork.
- Participant variances: For mortgage portfolios, impairment provision increased between 30 percent and 250 percent compared to IAS 39 and for other than mortgage portfolios the increase was between 25 percent and 60 percent.
- Downturn assumptions: Where downturn assumptions are used, the provision measured in accordance with the ED were between 80 percent and 400 percent higher for mortgage portfolios than for other than mortgage portfolios.

The interaction between loan impairment and regulatory capital

The current Basel regulatory measure of expected loss is in nearly all cases higher than the current level of impairment provisions taken under IAS 39. However, we believe that this relationship will change significantly under IFRS 9 and wanted better to understand banks' views on the linkage between Internal Ratings Based (IRB) approaches under Basel and IFRS 9 approaches to Expected Losses (EL). As not all of the banks in our survey are within the Basel framework and of those not all of them use an IRB approach, the following analysis of Figures 12 and 13 is based on replies from half of our survey population.

Figure 12. Do you expect that the provision for expected losses as proposed in the ED will be more or less than the existing IRB approach under Basel?

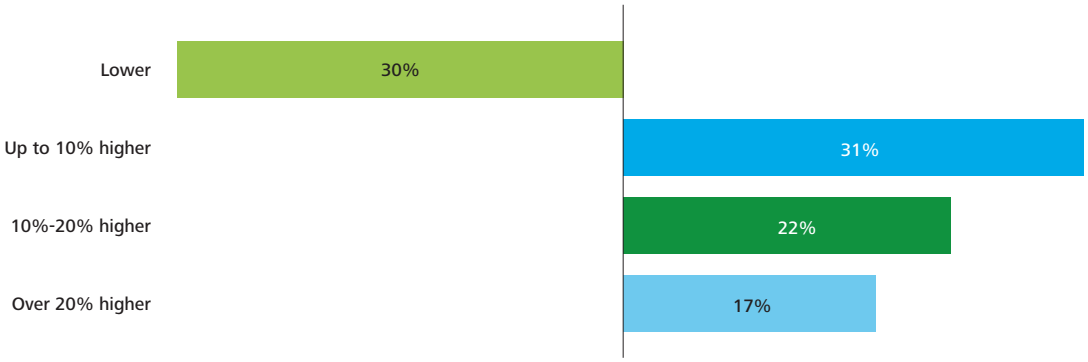
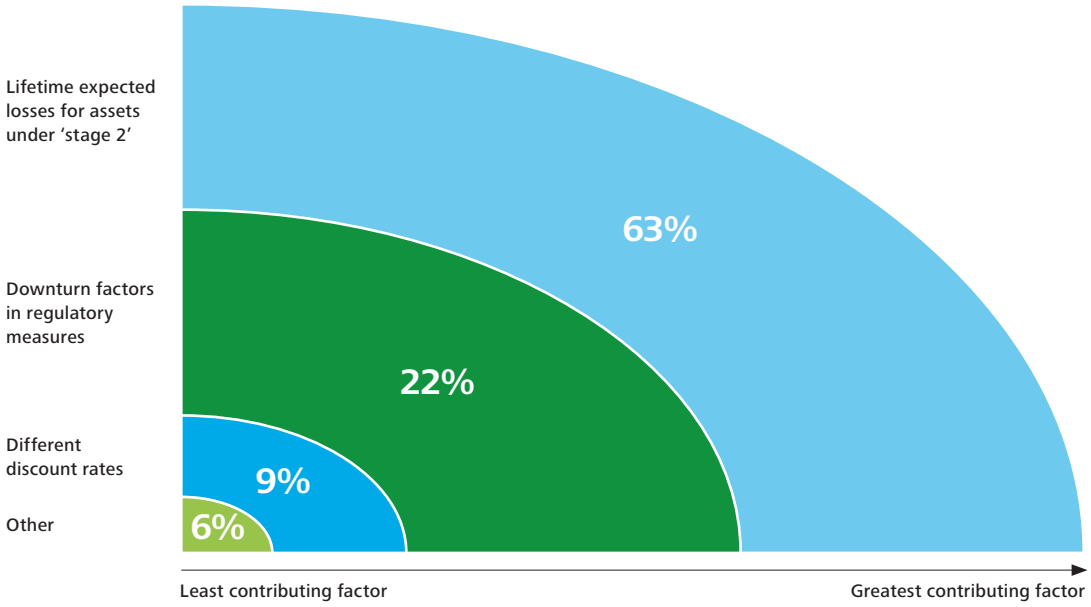


Figure 13. What do you see as the biggest contributing factors to differences between IRB expected loss and IFRS 9 as proposed?



In terms of the regulatory capital impact of IFRS 9, 70 percent of participants believe that the IFRS 9 total expected loss will exceed the IRB expected loss and therefore lead to increased core tier one capital requirement for banks under current capital rules.

Views on the size of the margin of the IFRS 9 expected loss over the IRB expected loss differ between participants with the largest group (30 percent) expecting an increase of up to 10 percent, reflecting that although lifetime expected losses are expected to cause a big difference between the two measures, this is balanced by the fact that the metrics used for regulatory capital (PD, LGD, Exposure at Default (EAD)) have more prudence designed into them (floored or reflecting downturn conditions) than the neutral measures used for accounting purposes.

Banks reporting the largest increases – that IFRS 9 expected losses will be more than 20 percent higher than the IRB expected loss – were exclusively European. There was not, however, a clear regional consensus as some European banks still expect their IFRS 9 expected loss provision to be smaller. The size of the bank also did not determine how it answered this question. For example, some G-SIFIs expect the IFRS 9 expected loss to be smaller than the IRB expected loss whereas others expected it to be larger.

Almost a third (30 percent) of the banks think their IFRS 9 provision will be lower than their IRB EL likely because of higher levels of Basel provisions for banks with historically low default portfolios as LGDs are floored (or subject to a regulatory minimum) under Basel.

Other sources of differences cited by banks in their responses to this question included a more conservative, risk-averse mood in the wake of the financial crisis as well as specific technical differences. This included the use of through-the-cycle PDs for IRB expected loss compared with point-in-time PDs for IFRS 9 expected loss, the different regulatory categories and calibrations used for IRB expected loss and additional factors imposed by the regulator.

> … the year-on-year trend is that banks are increasingly of the view that pricing will be affected.

The impact of IFRS 9 on product pricing

Where banks have to hold more regulatory capital as a result of accounting change which increases the size of the provisions against certain product lines, this will drive up the cost of capital for banks providing these products. We were interested in establishing whether this is likely to affect banks' pricing strategies. This is an area we have been asking about since the launch of our survey in 2011, and the year-on-year trend is that banks are increasingly of the view that pricing will be affected. When we first asked about this in 2011, 9 percent of banks thought that pricing might be affected by the expected loss impairment model. This year, 56 percent think that pricing will be affected across all major loan asset classes (i.e. corporate loans, SME loans and mortgages).

Hedge accounting

We wanted to assess banks' views on two hedge accounting developments that occurred in 2013. First, the IASB's tentative decision in April 2013 to permit IAS 39 hedge accounting requirements to continue once IFRS 9 is in force and second, their amendments to IAS 39 on the novation of derivatives.

We asked banks whether they expect to take advantage of the election to continue with IAS 39 hedge accounting after IFRS 9 is effective. We found that where banks have decided their approach, two-thirds plan to take advantage of the IASB's election. However, 64 percent of banks have not decided yet whether they will elect to retain IAS 39 hedge accounting under IFRS 9 – given that staying with their existing approach will require no additional work, there is no urgency around this.

The second development was in response to recent regulations that will require an increased use of central clearing houses for derivatives by banks, including the European Market Infrastructure Regulation (EMIR). To allow hedge accounting to continue when a derivative which has been designated as a hedging instrument is novated to effect clearing with a central counterparty, the IASB published in narrow-scope amendments to IAS 39 in June 2013. We asked if this amendment was sufficient to cover any significant novations of derivatives that have taken place or that banks expect to take place within their organization.

The majority (83 percent) of respondents indicated that the amendment would be sufficient to cover any significant novation of derivatives taking place or expected to take place, indicating the IASB's change will provide the intended relief. The 17 percent responding 'no' may consider the IASB's amendment to be too narrow for their circumstances.

… at the onset of a future financial downturn IFRS 9 may lead to more sudden provisioning for lifetime expected losses.

IFRS 9 and pro-cyclicality

Since the financial downturn, a criticism of financial instruments accounting has been that it fuelled inflated asset valuations because losses were recorded too late in the economic cycle. A more forward looking accounting approach will see losses booked sooner, and proponents hope that this will reduce the level of cyclicality. As the IASB's approach is for lifetime expected losses to be recognized where there is a significant deterioration in credit risk, this could mean that at the onset of a future financial downturn IFRS 9 may lead to more sudden provisioning for lifetime expected losses than has been experienced under the current IAS 39 model. The impact of earlier recognition of potential losses on economic decisions (such as remuneration or dividend decisions) is uncertain. We asked banks whether they thought that IFRS 9's impairment requirements will be more pro-cyclical than those of IAS 39.

Opinion is divided: 57 percent of banks think the IFRS 9 impairment requirements will be more pro-cyclical than current accounting under IAS 39, 43 percent think they will not. These different viewpoints reflect the fact that regulators' responses will be important in shaping the extent to which the accounting changes have a pro-cyclical effect on the wider economy.Deloitte UK's recent paper, *Going up? The impact of impairment proposals on capital requirements* examines whether capital rules will adapt to the change in accounting requirements.

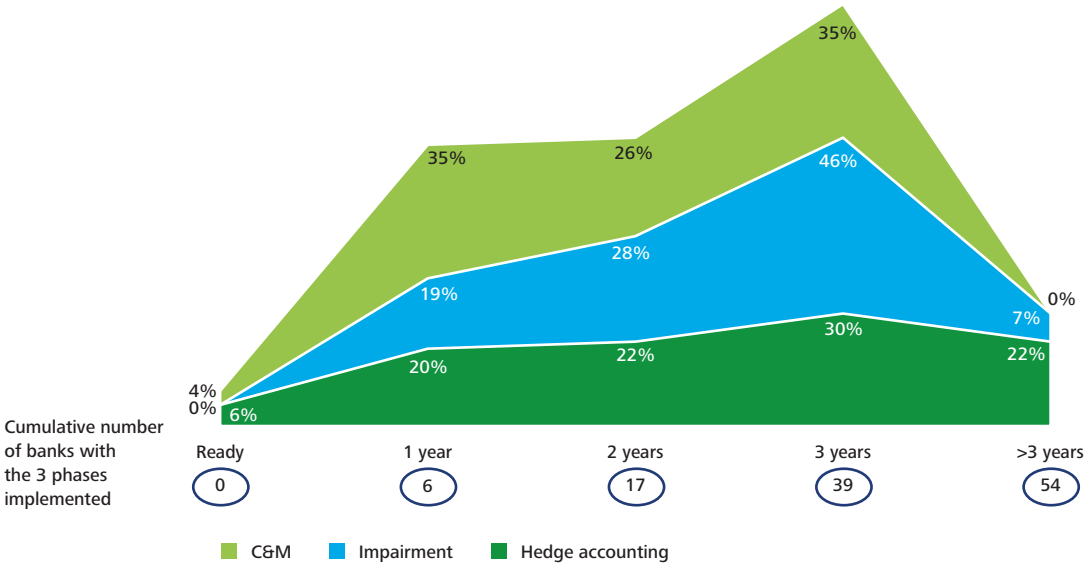
Regional differences also exist, as banks in the Asia Pacific region are less likely to consider the changes to be more pro-cyclical than banks in Europe. This may be because they have differing expectations about the manner in which impairment accounting and banks' capital requirements interact.

It is clear that regulators are generally seeking higher levels of capital to be held than in the past, but this will not necessarily reduce cyclicality in the wider economy. If very significant amounts of capital can be readily released by banks during downturns, and larger amounts are required to be held during the rest of the cycle, the effects of cyclical change may be softened. However, if banks cannot release their capital buffers easily – whether for regulatory reasons or because of concerns about stakeholders' perceptions – then this softening effect is unlikely to occur.

Implementing change

Project management

Figure 14. Assuming the remaining phases of IFRS 9 are finalized in the first half of 2014 how much time do you require to implement the standard?



Three years is most frequently cited as the necessary lead time for all phases of IFRS 9. Typically banks are implementing the components of IFRS 9 as a related set of workstreams which makes sense not least because the judgments made for classification and measurement purposes will determine whether instruments are held at fair value or amortized cost, and hence which financial instruments will be subject to impairment testing.

The three-year lead time most participants think they need will put banks' IFRS 9 implementation teams under pressure even with a 2018 effective date, given that the final standard is expected imminently and a large scale multi disciplinary project will in many cases be required to implement IFRS 9.

Figure 15. When did you start or when do you expect to start your IFRS 9 implementation project?

Impact Assessment	✔	✘
Hedge Accounting	19	35
C&M	33	21
Impairment	35	19

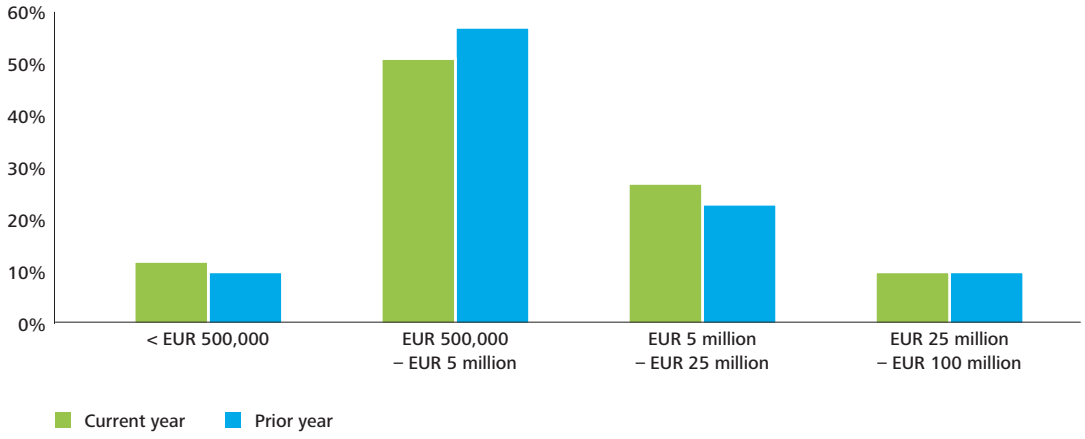
Design	✔	✘
Hedge Accounting	2	52
C&M	2	52
Impairment	5	49

Build	✔	✘
Hedge Accounting	1	53
C&M	1	53
Impairment	0	54

✔ Number of banks who have completed the project phase ✘ Number of banks who have not completed the project phase

Over a third of banks have not started their IFRS 9 project, and most are in the early stage of studying the quantitative and qualitative impact of the forthcoming accounting standard. Banks are awaiting the final standard before embarking on full scale implementation projects. In their own words, they need "Clarity as to the effective date and a final standard in order that detailed model and data build activity can commence." One bank remarked that "Even a small change could have significant impact on our approach. Therefore project phasing is contingent on the standard being available by the end of June."

Figure 16. What do you estimate as the total budget that you may require to meet the current and proposed IFRS 9 requirements?



The weighted average of budgets this year is €12 million, up from €11 million last year probably due to banks revising their estimates of the amount of effort involved as the standard nears finalization.

Implementation challenges

We asked banks what they consider to be the key challenges to delivering the IFRS 9 change program. They told us that uncertainty around timing of IFRS 9 is the biggest challenge which will shortly be resolved given the final standard is expected imminently. Other implementation challenges are coordinating finance, credit risk, IT and other teams and resource constraints affecting the financial reporting team and the availability of support from risk. This reflects our experience that whilst commonalities exist, banks face specific challenges based on their individual circumstances and a one-size fits all approach to implementing IFRS 9 across the banking industry will not work. It is encouraging to note that only seven respondents highlighted buy-in from senior leadership as a challenge.

Additional challenges cited by banks included uncertainty around regulatory, tax and U.S. reporting requirements, making it difficult to determine the scope of the project. Internally, systems development and reconciliation was also seen as a particular challenge. This is consistent with our work with banks, many of whom have a number of legacy systems operating largely independently of each other, and therefore find it difficult to capture credit risk information that readily aligns with the financial reporting numbers.

Implementation challenges are coordinating finance, credit risk, IT and other teams and resource constraints affecting the financial reporting team and the availability of support from risk.

Modelling options and key challenges for institutions around the modelling exercise
The IASB model focuses on the requirements that the impairment calculation needs to meet, rather than being prescriptive with regard to the modelling approach taken. This presents an opportunity for firms to align the target IFRS 9 design with existing data and processes, and to apply the lessons learned across the industry during similar programs to deliver IRB approaches. There are a number of impairment modelling options available which will determine the business-as-usual flexibility of the final solutions. However, before the models can be selected, the principles which they are seeking to achieve should be clearly established.

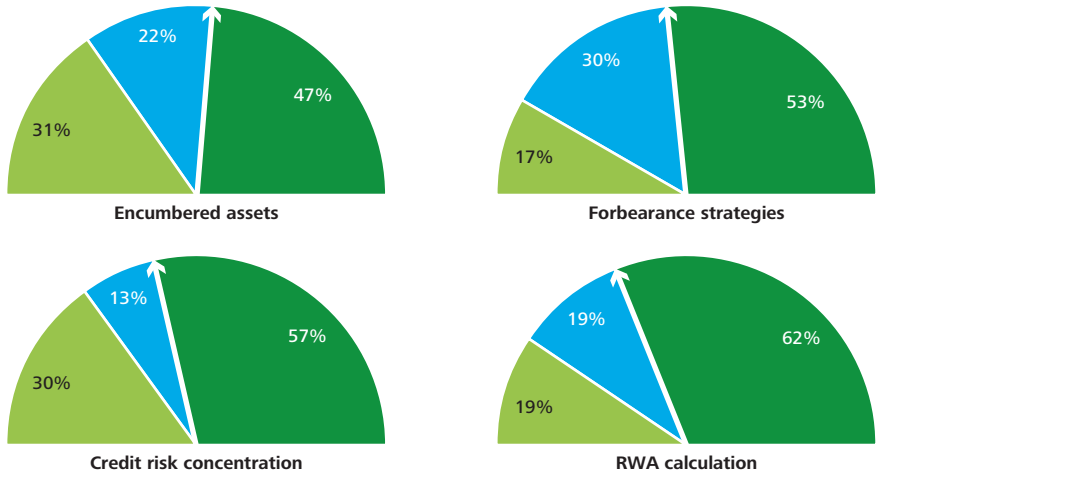
- **Granularity** – Account or customer level will provide the most comprehensive solution which is likely to be more future proof whereas aggregated estimates and calculations at segment or portfolio level are likely to be more achievable in the short term, but carry a longer term maintenance cost.
- **Sophistication** – Finding the right balance between complexity, practicality and accuracy will vary between institutions, potentially leading to greater variances across the industry over time.
- **Impairment philosophy** – Using a bottom up modelling approach with no adjustments could be considered a pure interpretation of the IASB model but will carry increased complexity to fully capture the lifetime behavioural and macroeconomic impact, whilst top down overlays will provide management flexibility but require strong governance.

Forward looking lifetime expected loss impairment models will introduce operational complexity across risk and finance with specific challenges for firms offering multiple credit products across multiple jurisdictions. Selecting the right level of model sophistication, at the right level of granularity and to meet the target philosophy will be required.

Disclosure

The appetite for information from banks is large and growing. To help banks meet growing expectations, the EDTF produced a report, *Enhancing the risk disclosures of banks* in October 2012. Aimed in the first instance at the world's biggest and most complex banks, the disclosures include many straight-forward suggestions that could readily be adopted by banks of any size. In addition to the EDTF's initiative, regulators, politicians and others have been calling for more transparent reporting. For example, the FSB wants more data on 'shadow banking' activities; and more transparency around risk-weighted assets (RWA) is sought by many national regulators. How are banks planning to respond to this?

Figure 17. In the light of the EDTF's report on banks' risk disclosures, are your annual report disclosures changing in these areas?



Yes we have recently expanded our disclosures
Yes we plan to increase our disclosures in our next annual report
No, we do not propose to make any additional disclosures

Encumbrance (53 percent) and forbearance (47 percent) are the two areas where banks are more likely to have recently expanded, or have plans to expand, their disclosures, with a smaller proportion of banks planning changes to their disclosure around credit risk concentration or RWA. We identified some regional differences in responses, with banks in Asia Pacific who have generally been less adversely affected by the financial downturn being less likely to be making disclosure changes than European and North American banks.

Some banks have yet to decide how they will respond to the EDTF's recommendations. Others have an incremental approach planned, providing more qualitative information on forbearance in their 2013 report and then supplementing this with more quantitative information in 2014.

We asked banks whether they need to make IT systems changes in order to support increased public disclosure and 64 percent of respondents replied that they would. This is unsurprising, as existing systems are generally not designed to capture some of the information that will be required for financial reporting purposes. G-SIFIs were more likely to answer 'yes' to this question, consistent with the high degree of public scrutiny they are currently receiving as well as the complexity and breadth of their current portfolios, processes and data sources.

Banks in the Asia Pacific region were amongst those that do not consider IT changes necessary. This may be because they are under less pressure from their regulators to develop their disclosure than their European and North American peers or because their existing IT systems are newer and more flexible.

List of acronyms

AFS	Available for Sale
ASC	Accounting Standards Codification
AQR	Asset Quality Review
DTTL	Deloitte Touche Tohmatsu Limited
EAD	Exposure at Default
EBA	European Banking Authority
ECB	European Central Bank
ED	Exposure Draft
EDTF	Enhanced Disclosure Task Force
EIR	Effective Interest Rate
EL	Expected Loss
EMEA	Europe, Middle East and Africa
EMIR	European Market Infrastructure Regulation
FASB	Financial Accounting Standards Board
FSB	Financial Stability Board
G-SIFI	Global Systemically Important Financial Institution
IASB	International Accounting Standards Board
IAS	International Accounting Standard
ICAAP	Internal Capital Adequacy Assessment Process
IFRS	International Financial Reporting Standard
IRB	Internal-Ratings Based
LGD	Loss Given Default
OCI	Other Comprehensive Income
PD	Probability of Default
RWA	Risk-Weighted Assets
SEC	Securities and Exchange Commission
SPPI	Solely Payments of Principal and Interest

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Notes

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