

Going up?

The impact of impairment  
proposals on regulatory capital



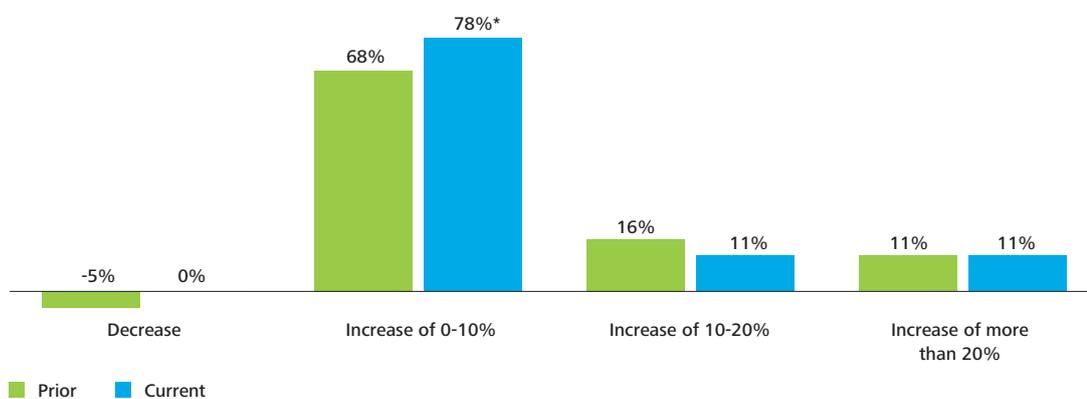


## Credit institutions' regulatory capital levels are under the spotlight and will continue to be for the foreseeable future. What would the IASB's recent impairment proposals mean for those responsible for managing regulatory capital levels?

In March 2013, the International Accounting Standards Board (IASB) issued its third Exposure Draft (ED) on impairment of financial assets (ED/2013/3 Financial Instruments: Expected Credit Losses). The subsequent debate has moved on from the technical merits of the proposals to the quantitative impact of the ED on banks' balance sheets. In particular, the likely size of the increase in impairment provisions and the anticipated response by policymakers responsible for regulatory capital regulation of credit institutions have attracted attention, in the light of continuing pressure for credit institutions to raise capital ratios. The effect of the proposed standard on regulatory capital planning is likely to be significant, as illustrated by responses from credit institutions across the world to Deloitte's 'Third Global IFRS Banking Survey' (see figure 1). The IASB's recent staff fieldwork has showed even more significant increases.<sup>1</sup> Although the final impairment requirements to be included in IFRS 9 will affect IFRS reporters in all sectors of the economy, the impact is going to be greatest for credit institutions.

**Figure 1. The effect of the proposed standard on regulatory capital planning**

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



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

Source: Deloitte: Third Global IFRS Banking Survey, January 2013

In this paper we consider the potential impact of the impairment standard and actions that credit institutions can take to prepare for the possible regulatory outcomes and that firms should be considering regardless of regulatory decisions. In particular, in summarising the differences between the ED and the existing Basel treatment of expected losses, we highlight changes that will be required to Basel models (where used) in order to comply with the proposed impairment accounting model. The impact on the components of the capital framework such as the calculation of unexpected losses and capital buffers is also addressed.

1. IASB staff paper: 'Outreach Feedback Summary – Fieldwork'

Our initial analysis suggests that:

- The impairment requirements being developed for IFRS 9 will probably lead to significantly greater provisioning levels than those made under IAS 39, and impairment provisions are also likely to be in excess of existing expected loss calculations used for Basel purposes.
- The prudential regulatory response to the proposed IFRS 9 changes is uncertain; however regulators are still likely to require further credit losses to be factored into capital calculations.
- Institutions affected should do more than wait for regulators. Whilst there is uncertainty about how the various Basel buffers will work together, firms should consider their own internal buffers and internal target level of capital. The IFRS 9 proposals might lead to a change in the required size of this buffer, as the change in IFRS 9 impairment levels under a stress scenario is likely to be different to the change in IAS 39 impairment levels under a stress scenario.
- The introduction of a measurement requirement for full lifetime expected losses for assets that are short of default, but have deteriorated since inception, adds a significant uncertainty to institutions' capital numbers. This estimate will be out of management control, often being based on third party sources such as economic forecasts. It will be important to be able to communicate changes in these assumptions to investors.
- Although the proposals of the ED are likely to increase capital constraints further for regulated credit institutions, there are potential benefits from the increased transparency and reduced uncertainty over balance sheet loan valuations arising from the proposals, which may make capital raising and funding easier and cheaper.

#### Overall direction of the potential regulatory capital impact of the ED

In summary, the impairment proposal will, if implemented, have a significant impact on capital management. Those ultimately responsible for capital management (which varies between Finance Director and Chief Risk Officer in most credit institutions) should consider the proposals a 'risk' to the long-term capital position of the institution, albeit one that cannot at this stage be precisely quantified. Once initial assessments have been undertaken on the impact of the requirements of the ED, quantification of the most demanding regulatory treatment should be considered, and the sensitivity of capital plans to different regulatory responses examined. In addition to this, the calculation of the internal capital buffer that the institution itself thinks is necessary should be computed.

#### Current and future accounting and capital regulation – a recap

The link between accounting impairment and regulatory capital will need to be considered and potentially revised by regulators following introduction of the new impairment rules into IFRS 9; a point made by the European Banking Federation (EBF) in its letter to the Basel Committee in June 2012, requesting that the Committee revisit the Basel capital accord following the agreement of an expected loss accounting standard. The EBF also suggested that the forthcoming impairment accounting requirements would require a re-calibration of the Basel III countercyclical and conservation buffers.

Table 1. Current and future accounting and regulatory provisioning frameworks

	Accounting	Regulatory
<b>Current</b>	IAS 39 'incurred loss model' of impairment. A financial asset or group of assets is impaired, and impairment losses are recognised, only if there is objective evidence as a result of one or more events that occurred after the initial recognition of the asset.	Basel 2.5/Basel 3 (depending on national implementation) – treatment of accounting provisions as set out in table 2.
<b>Future</b>	IFRS 9 expected loss model segments loans and loan commitments that are not measured at fair value through profit or loss into three 'stages' (if the latest ED was finalised): <b>Stage 1</b> – performing assets not subject to a significant increase in credit risk since initial recognition – recognise 12 months of expected losses; <b>Stage 2</b> – assets where the credit risk of the assets has increased (or credit quality deteriorates) significantly and the resulting credit quality is below 'investment grade' – full lifetime expected credit losses would be recognised; and <b>Stage 3</b> – assets where the credit quality of the asset has deteriorated to the point that credit losses are incurred or the asset is credit-impaired – full lifetime expected credit losses would be recognised.	Basel 3.5? Treatment of accounting provisions in regulatory capital will be decided once the final IFRS 9 standard is issued.

### What will regulators want from an IFRS 9 impairment standard?

It is often thought that regulatory capital and financial reporting have differing objectives and stakeholders, with the former serving a forward-looking purpose of depositor protection and financial stability, whilst the latter is a neutral account of past stewardship. However, in the area of loan impairment, regulators do in effect place significant reliance on accounting standards and the auditing of implementation of standards in determining the level of capital held by credit institutions. Regulators today have the following concerns with accounting standards in the area of impairment:

- Impairment provisions are not taken early enough. For example, the Bank of England and UK Financial Policy Committee (FPC), and more recently the European Banking Authority (EBA), have been concerned by distressed loans (particularly in the commercial real estate sector) for which impairment provisions may not have been taken under the IAS 39 incurred loss approach. The UK's Parliamentary Commission on Banking Standards has voiced similar concerns in its report 'Changing Banking for Good'.
- The subjectivity afforded to firms causes a lack of comparability between the impairment provisions of different credit institutions. To some extent, disclosures, such as the risk disclosures recommended by the Enhanced Disclosures Task Force (EDTF), can help users of accounts compare methodologies.

The regulatory capital regime is pro-cyclical: as capital requirements increase and capital resources decrease as credit institutions move to the 'trough' of the economic cycle (which is the point at which they are least able to raise capital from capital markets). Existing practices under IAS 39 contribute to this by not reflecting expected losses in the run-up to an economic crisis that may be expected to occur.

It could be argued that the ED responds to these points to some degree by accelerating loss recognition and providing additional credit risk disclosures. However, moving to an expected loss model from an incurred loss model is bound to require greater levels of judgement and subjectivity because of its reliance on expectations of the future. In response to this, regulators may insist on further disclosures to assist comparability. Further, the ED provides only for expected losses, not unexpected losses, so regulators may require more capital to be set aside in the good times to reduce further pro-cyclicality.

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## Existing treatment of impairment provisions in regulatory capital – a recap

### Capital resources treatment

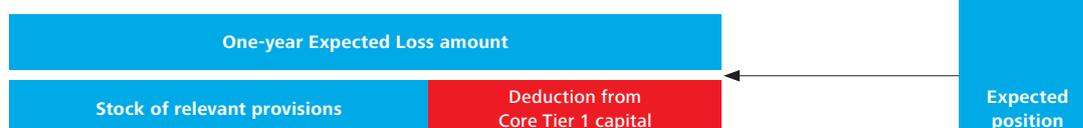
Increasing the level of impairments reduces the level of accounting net assets. However, in calculating regulatory capital resources, there are differing adjustments made to accounting impairment raised on assets held in the regulatory 'banking book' in the regulatory capital rules. This depends on whether the asset is subject to the standardised or internal ratings based (IRB) approach to the calculation of capital requirements associated with credit risk. The following analysis treats Basel III rules as the 'existing' rules given that they have been implemented – or will be shortly – in the majority of jurisdictions with systemically important financial sector entities.

**Table 2. Treatment of impairment provisions in definition of regulatory capital resources**

Method	Description	Treatment of impairment
Standardised	Used by smaller credit institutions	Any impairment loss on a loan taken to the income statement has a 1:1 impact on Core Tier 1 capital as it reduces retained earnings. However, the cumulative collective impairment provisions <sup>2</sup> can be eligible to count as Tier 2 capital resources up to a 'ceiling' of 1.25% of Risk Weighted Assets (RWAs) calculated under the standardised approach. An example of such impairment provisions would be those held to cover latent (incurred but not reported) losses on a pool of performing residential mortgages.
IRB	Most major credit institutions have applied for the IRB approach on some or all lending portfolios, which allows for credit institutions to use their own computations of capital requirements. To obtain this approach, at least 85% of RWAs must be subject to the IRB approach (in order to prevent selective use of internal modelling for those portfolios for which internal models are most beneficial).	The IRB approach uses a one-year time horizon, and introduces the concept of Unexpected Loss (UL) and Expected Loss (EL) over that period. In essence, in the definition of eligible capital resources, the EL replaces the stock of accounting impairment provisions on portfolios subject to measurement on the IRB approach (as long as the EL exceeds accounting impairment). However, in scenarios where the accounting impairment stock is greater than the EL, the surplus over the EL is allowable to count as tier two capital resources up to a ceiling of 0.6% of RWAs.

**Figure 2. Illustration of impact of existing prudential treatment of provisions**

*Basel III treatment: Scenario 1: One-year EL higher than provisions*



*Basel III treatment: Scenario 2: Provisioning stock higher than one-year EL*



2 In its draft Regulatory Technical Standards on the calculation of credit risk adjustments, the EBA has defined such provisions as having the following characteristics:

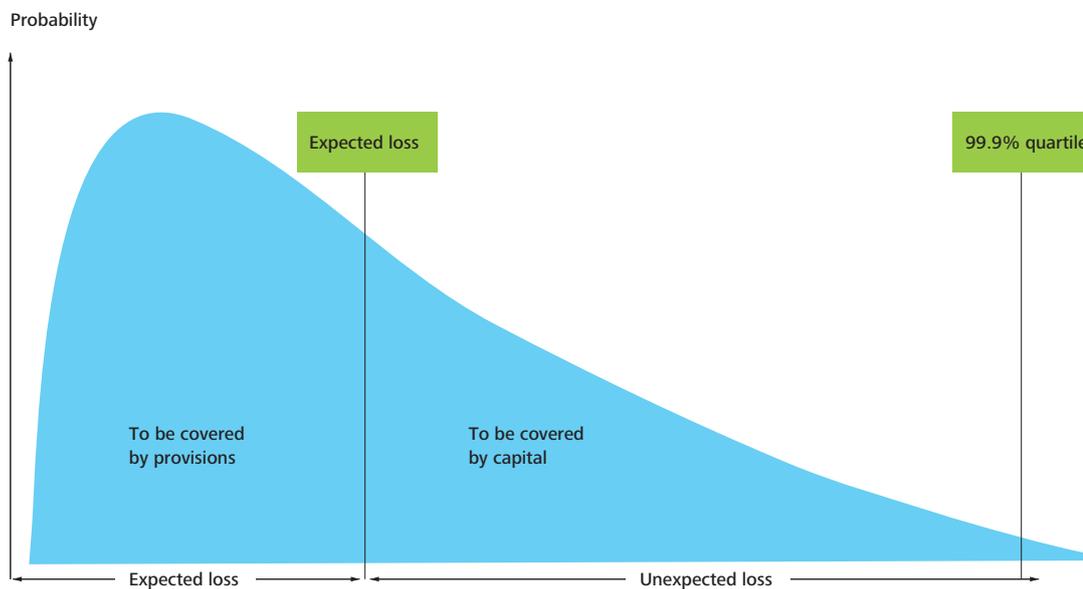
- (a) are freely and fully available, as regards to timing and amount, to meet losses that are not yet materialised;
- (b) reflect credit risk losses for a group of exposures for which the institution has currently no evidence that a loss event has occurred.

### Capital requirements treatment

Regulatory capital requirements are calibrated to measure the unexpected losses rather than the expected losses an institution faces. Under the Basel accord, capital resources are expected to be held aside for unexpected credit losses over a one-year time horizon.

Under the standardised approach, capital requirements are calculated as a percentage of exposure net of specific impairments raised. Under the IRB approach, due to the concept of IRB expected loss, unexpected loss is calculated based on a function of exposures gross of specific impairments and other factors including Probability of Default (PD), Loss Given Default (LGD), and maturity, minus expected losses.

Figure 3. The distribution of unexpected and expected losses



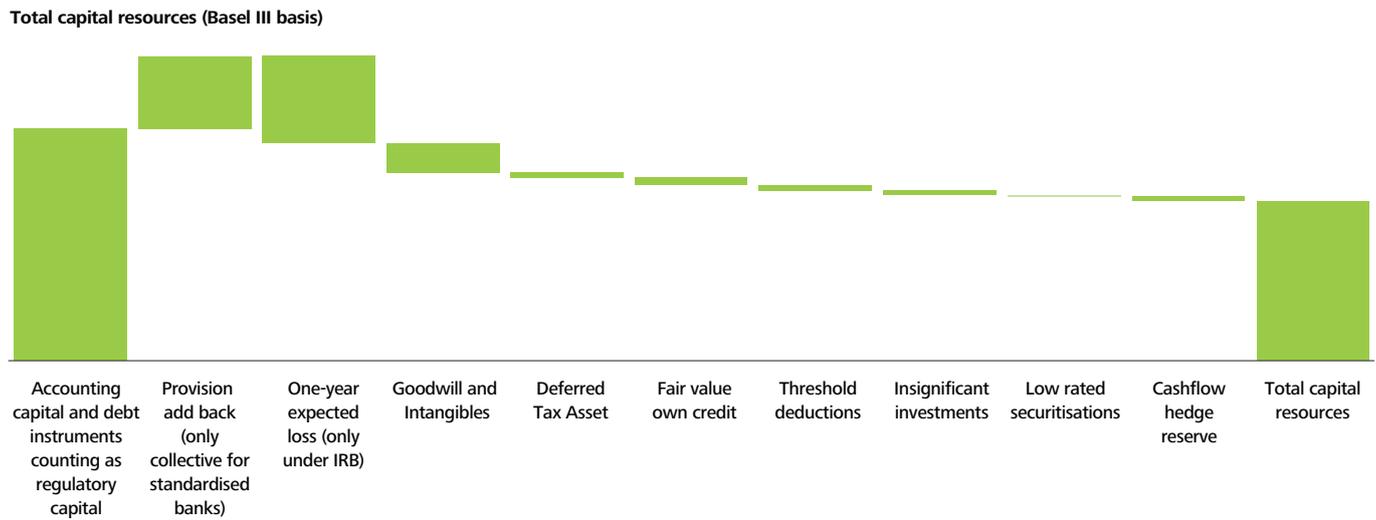
### Capital Buffers

The purpose of capital buffers is to ensure a firm has sufficient capital resources to withstand the financial impact of prolonged severe but plausible stress scenarios and still maintain adequate capital resources (allowing for plausible management actions). Under Basel III, two new capital buffers have been introduced in addition to the minimum capital requirements. The countercyclical buffer aims to build up capital resources at the peak of the economic cycle (and is only a requirement at this part of the cycle); partly to mitigate the fact that the existing loan impairment rules under IAS 39 are relatively low due to fewer incurred loss events. The conservation buffer provides a buffer above the minimum 8% capital requirement to absorb any stresses. The use of this buffer, for example if a credit institution suffers significant impairment losses during the downturn of an economic scenario, triggers restrictions on payments of dividends and bonuses, providing a disincentive to having to draw on it routinely.

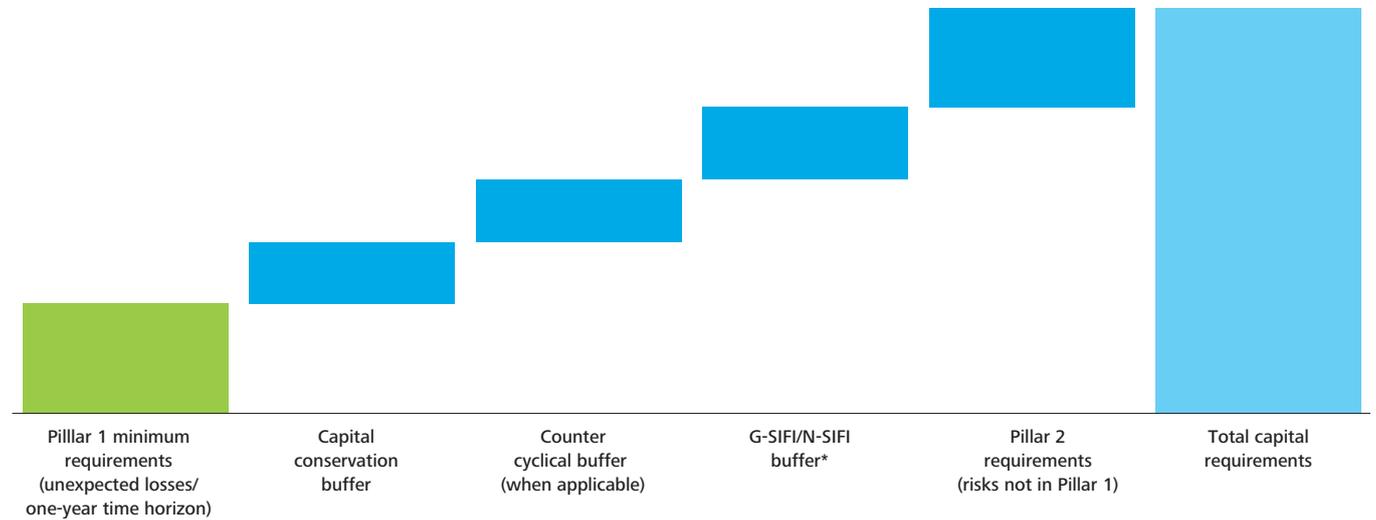
These additional Basel III buffers equate to an incremental requirement of 5% of RWAs above the 8% minimum ratio under Basel III (on full implementation).

Figure 4 below shows the definition of regulatory capital resources. Figure 5 shows the build-up of regulatory capital requirements and capital buffers which credit institutions are required to meet.

**Figure 4. Composition of credit institutions’ capital resources – illustration of a hypothetical bank’s capital resources build-up**



**Figure 5. Composition of credit institutions’ capital requirements**



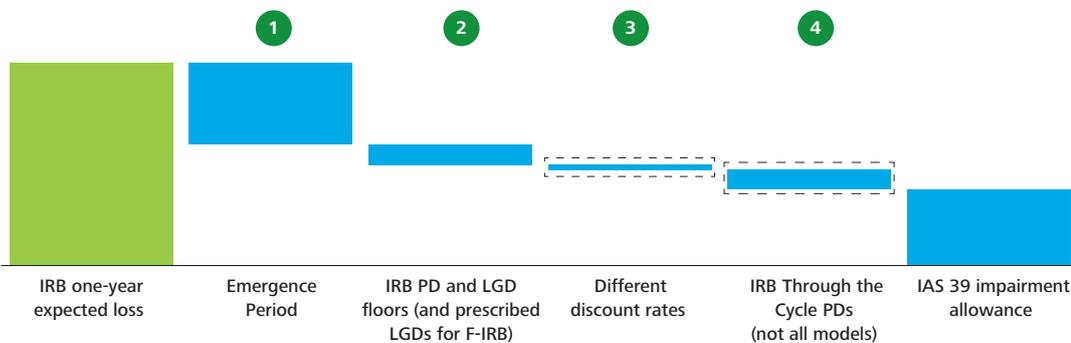
\* Additional capital surcharge for financial groups deemed systemically important to the financial stability of either their national financial system or to the global financial system (Global systemically important financial institutions (G-SIFI); National systemically important financial institutions (N-SIFI)).

**Reconciliation between IAS 39, IFRS 9 and IRB expected loss**

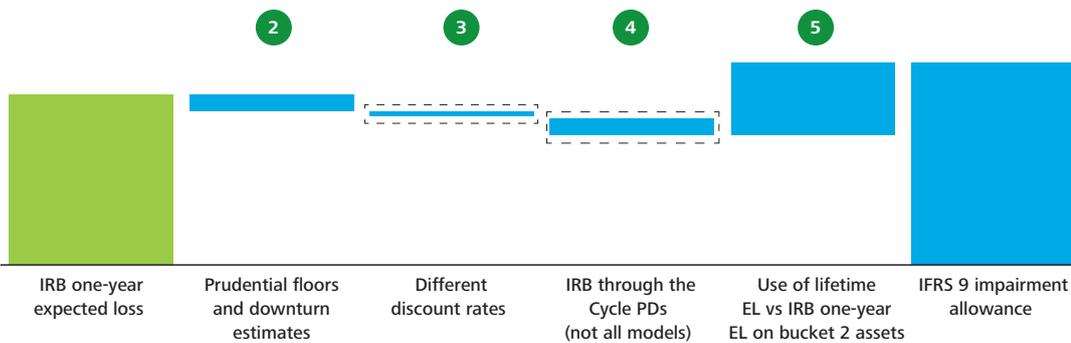
Many larger credit institutions might today expect that the capital deduction that they apply for the IRB one-year expected loss (which effectively replaces the IAS 39 accounting impairment with the one-year EL) will be sufficient to cover the impact of reduced levels of accounting capital as a result of moving to the new impairment rules in IFRS 9. From a sample of 2011 and 2012 Pillar 3 returns of European credit institutions that adopt the IRB approach (comparing the expected loss and impairment allowance for those assets under the IRB approach at the same reporting date, as mandated by Pillar 3 disclosure rules), we estimate that the accounting impairment stock for assets under the IAS 39 rules ranges from 60% to 90% of the one-year IRB EL.

A summary of the difference between the IRB EL and the IAS 39 methodology is shown below, and in almost all cases the IAS 39 allowance will be lower than the IRB expected loss due to the factors noted.

**Figure 6. Reconciliation between IRB one-year expected loss and IAS 39 impairment**



**Figure 7. Reconciliation between IRB one-year expected loss and IFRS 9 impairment**



1 - 5 : Explanation provided on page 8

1

### Emergence period

Under IAS 39, no provisions should be held against performing loans. However, many credit institutions make use of an emergence period methodology (as displayed in figure 6) which calibrates expected losses over a period between a loss event occurring and it being evidenced, for example the time period between loss of employment and the identification of a missed payment. Typically, emergence periods used by credit institutions are under one year and hence this causes a significant difference between the regulatory and IAS 39 measure. However, the proposed mandatory twelve-month expected loss calculation for assets in stage 1 of the IFRS 9 model will help converge the two measures.

2

### Prudence of Basel parameters versus neutrality of IFRS 9 proposals

The IRB expected loss calculations use a number of concepts which are not consistent with an accounting framework which focuses on neutrality rather than prudence, and this remains the case when Basel parameters are compared to the IFRS 9 impairment proposals.

- The IRB expected loss approach uses PD and LGD floors, as well as fixed LGDs for the loans under the Foundation IRB approach;<sup>3</sup> and
- LGD and conversion factors used in calculating Exposure at Default parameters in the IRB model must be appropriate to an economic downturn (this is often referred to as 'downturn LGD' and 'downturn EAD').

3

### Discount rate

A number of credit institutions have informed us that the choice of discount rate is a key judgemental issue arising from the IFRS 9 impairment proposal. The discount rate used for IRB expected loss purposes will be the cost of equity or cost of funds whereas for IAS 39, the discount rate used is the effective interest rate. However, the IFRS 9 discount rate should be between the risk-free rate (the rate for high quality government debt) and the effective interest rate (EIR) where loans are in stage 1. Depending on the yield of the loan, the discount rate used in determining the accounting impairment could be lower or higher than the IRB discount rate (indicated by a dashed line).

4

### Through the cycle and point in time

The use of through the cycle (TTC) probabilities of default in IRB models has been motivated by the desire of credit institutions and regulators for capital requirements to be countercyclical. A TTC model calculates the PD of a loan or group of loans based on underlying drivers of credit risk that do not change during an economic cycle and hence the PD for such loans does not change prior to the loan entering default. This rating system therefore is not sensitive to movements in the underlying economy. However, it is sensitive to a change in level of risk of the lending granted.

As the majority of IRB model philosophies are based on a TTC approach, the key result of this is that in economic downturns, the PD used in the IFRS 9 Expected Loss model is likely to overshoot the TTC PD used for the IRB Expected Loss. The converse will be true in upturns in the economic cycle. As a result, the IRB expected loss and IFRS 9 expected loss may exceed each other at different points in the economic cycle (again indicated by a dashed line).

5

### Lifetime losses under IFRS 9

The key area where the impairment proposals may be significantly higher than the IRB expected loss is where assets are in stage 2 under the IASB's proposals and there has been a significant deterioration in credit quality, and the assets are thus subject to measurement of lifetime expected losses. Assets in stage 3 are also subject to calculation of lifetime expected losses. However these assets are likely to be considered in 'default' and subject to lifetime expected losses for regulatory purposes as well, subject to the definition of default being aligned between the accounting and regulatory measures. This is shown graphically in figure 7. The recent IASB staff paper<sup>3</sup> on outreach work has shown that the use of lifetime expected losses will particularly impact mortgage portfolios and this impact will be different across different jurisdictions, given the incentives to make payments of principal for mortgages vary over jurisdiction.

3. 'The Foundation IRB Approach' is an intermediate methodology under which the firm uses its own PDs, but uses LGDs and EADs that are stated in the regulatory rules.

## Potential regulatory reactions and treatment of IFRS 9 impairment provisions in regulatory capital

Regulators are likely to wait until the forthcoming impairment requirements are finalised and estimates of the impact on individual credit institutions are available, before announcing their response. This will cause uncertainty to many institutions, who will need to develop ahead of time capital plans which can be adapted to different regulatory decisions.

### Impact on capital resources

Table 3. Potential options on the calculation of capital resources for regulators

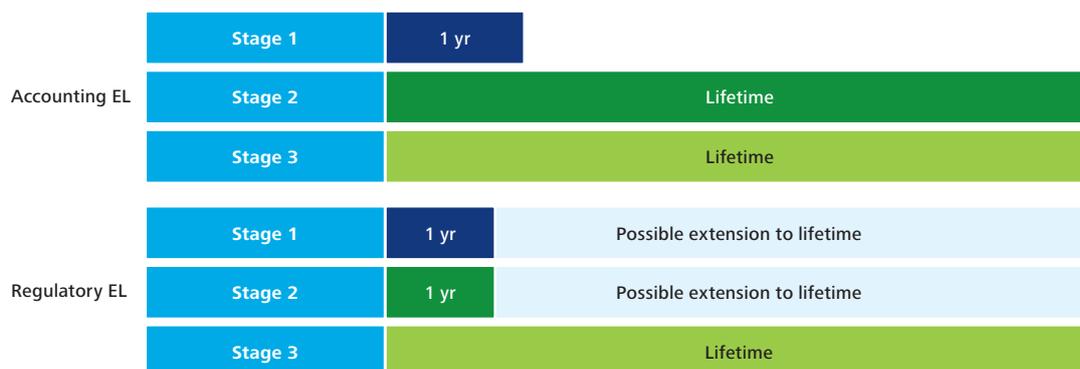
Option	Option for regulator	Rationale and disadvantages	Impact on IRB credit institutions	Impact on standardised credit institutions
1	Continue current treatment of impairment provisions in regulatory capital, with continued inclusion of some provisions in Tier 2 capital up to a limit.	It would seem counterintuitive that a portion of expected losses taken under IFRS 9 could count as regulatory capital, albeit as Tier 2 capital.	<p>This would be regulatory capital neutral, if the resulting provisions under IFRS 9 did not exceed the percentage of RWA limit up to which tier two provisions can count towards Tier 2 capital.</p> <p>However, if the IFRS 9 provision exceeded the IRB EL, the excess would be counted as Tier 2 rather than Tier 1 capital. Tier 2 is deemed lower quality by analysts (who tend to focus on Tier 1 ratios).</p>	<p>As there is no concept of IRB EL under the standardised approach, any increase in provisions on moving to IFRS 9 will reduce Tier 1 capital.</p> <p>However, it is likely that most or all of the incremental IFRS 9 provisions would be deemed to meet the criteria to count as Tier 2 capital, as long as these do not exceed defined limits set out in table 2.</p>
2	Remove IRB one-year expected loss concept, and take impairment allowance 1:1 from regulatory capital.	<p>Although such an option would remove complexity, the one-year expected loss is a useful backstop in the regulatory capital regime.</p> <p>There is a possibility that without the IRB expected loss, regulatory capital would increase under IFRS 9 (if IFRS 9 provisions turned out to be lower than the IRB EL).</p>	<p>The capital impact would depend on the size of the increase in impairment under IFRS 9.</p> <p>For IRB firms, the impact would be mitigated by the deduction already taken today for the difference between IRB EL and IAS 39 provisions.</p> <p>IRB firms would benefit (from a capital perspective) if the IFRS 9 figure ended up being lower than the IRB expected loss figure but would not if the IFRS 9 figure is much higher.</p>	Standardised firms would be affected as they would no longer be allowed to count provisions taken against performing loans as Tier 2 capital.
3	Remove the rules that allow recognition in Tier 2 capital of collective provisions (under the standardised approach) and surplus provisions above the one-year IRB expected loss under the IRB approach.	This would appear a likely outcome given that allowing expected loss provisions to count as regulatory capital resources, might appear imprudent.	<p>The size of impact would depend on how significant the increase in impairment provisions is under IFRS 9.</p> <p>For IRB firms, the impact would be mitigated by the deduction already taken for the difference between IRB EL and IAS 39 provisions.</p>	Standardised firms would be affected as they would not be allowed to count provisions against performing loans as Tier 2 capital.
4	Remove IRB one-year expected loss concept and propose that for all assets, expected losses over the lifetime of the asset (or over a period of more than 12 months for assets in stage 1) are recognised immediately against regulatory capital.	<p>Regulators may not consider the treatment of expected losses under stage 1 to be sufficient.</p> <p>The rationale for such a treatment would be that a 12-month horizon is not sufficient as the life of many loans is greater than 12 months. Such an approach was taken by the UK Prudential Regulatory Authority (PRA) in its recent capital exercise where it adjusted the capital base for three years of expected losses.</p>	<p>Such a move by regulators to adjust accounting values for regulatory capital purposes would significantly reduce capital resources, unless:</p> <ul style="list-style-type: none"> <li>• The loans of the bank in question have a very low PD if they do not default in the first year following origination; or</li> <li>• Have short behavioural maturities (i.e. lifetime expected losses are not significantly greater than expected losses over a one-year time horizon).</li> </ul>	

Although the impairment proposals contained in the IASB's ED appear more prudent than the existing Basel rules in using lifetime rather than one-year expected losses for assets, regulators may decide to move towards an IFRS 9 approach for the time horizon over which expected losses are calculated, and they could propose this not only for stage 2 credit deteriorated assets, but for the better quality stage 1 assets as well.

Figure 8 summarises the difference in approach between the impairment proposals contained in the ED and IRB expected loss. Regulators could move towards a lifetime default rate for stage 2 assets and potentially even stage 1 assets (if they do not believe the accounting proposals go far enough in increasing loan provisions) as described under option 4 in table 3, and hence capture some of the losses in the shaded box in the diagram.

It should be noted that although the cumulative PD of most types of loans falls over time (and in the case of some portfolios such as car loans, the loans that default generally do so in the first year), and hence the impact of such an approach would depend on the loan type.

**Figure 8. Difference between regulatory and accounting expected losses by time horizon**



### Impact on capital requirements

Options 2 and 3 of table 3 might reduce credit institutions' capital resources, and option 4 would almost certainly reduce capital resources potentially prompting a need for a significant new capital raising.

Institutions might argue that such a significant regulatory deduction to capital resources to cover expected losses, should be at least be partly offset by a reduction in capital requirements (which are to cover unexpected losses), which as noted earlier are calibrated to capture unexpected losses over a one-year time horizon. However, it would be prudent to assume that a move to an option 4 approach would not quickly be accompanied by any regulatory relief in the calculation of unexpected losses.

### Impact on capital buffers

The other significant question is whether, on adoption of an expected loss standard, any reduction in capital resources driven by the impact of the new accounting standard can be offset by a reduction in the calibration of the countercyclical and capital conservation buffers (as well as any further buffers applied by national regulators). The new accounting rules were not designed to address pro-cyclicality and therefore it would not be prudent to expect any reductions in the Basel III buffers, or those set by national regulators.

The recent IASB staff paper<sup>4</sup> found that the IFRS 9 model was more responsive than the IAS 39 model to changes in the macro-economic environment, and that this responsiveness is particularly significant for mortgage portfolios. This could of course lead to firms having to hold even bigger capital buffers if the responsiveness of IFRS 9 to severe macro-economic scenarios is greater than IAS 39, in order to ensure that minimum capital requirements can be met at all times.

<sup>4</sup> IASB staff paper 'Financial Instruments: Impairment' (22-26 July 2013)

## Conclusion

In all likelihood, capital resources at credit institutions will fall if the ED is finalised as is, as the impairment provisions calculated under IFRS 9 would likely be higher than the Basel expected loss due to the impact of the measuring lifetime expected losses on stage 2 assets. In the current climate, regulatory capital requirements and related buffers are unlikely to fall, even though there may be some conceptual rationale for this if impairment provisions increase. It is always possible that regulators could impose even greater adjustments to accounting values once the final accounting rules are finalised and the impact on credit institutions is assessed.

Those responsible for capital planning and those with ultimate responsibility for managing capital in institutions should start to make assessments of the potential capital impact against the one-year Basel IRB expected loss as a starting point, whilst being aware that regulators may decide to pursue an even more demanding option. This analysis will be particularly valuable in conversations with regulators and ratings agencies. In all cases, this will require finance and risk functions in credit institutions to work particularly closely in the coming months. Furthermore, relationship managers and first line business functions will need to be aware of the impact such changes to regulatory capital have on pricing and lending decisions.

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