Impairment — assessing the impact of the new proposal

The International Accounting Standards Board (IASB) has made significant progress in their new “three-bucket” credit impairment approach. The guiding principle of the new approach is to reflect the general pattern of deterioration in credit quality based on expected, rather than incurred, losses. The new approach to impairment will affect various types of financial assets (loans, debt securities, receivables, etc.) and both financial and non-financial institutions.

The Boards are planning to issue a new exposure draft on impairment in the second half of 2012. The expected effective date for IFRS 9 Financial Instruments: Impairment is 1 January 2015.

In this publication, we briefly summarise the current proposals and our views on the next steps for financial institutions in light of the status of the proposals. For further details of the proposals, please also see our publication, Impairment — a major step forward in achieving convergence, which can be found at www.ey.com/ifrs.

Background

The Boards continue to redeliberate their “three-bucket” expected loss approach to the impairment of financial assets. At their joint Board meetings over the last few months, the Boards agreed on several tentative decisions addressing the following critical conceptual questions and application issues:

- All financial assets are initially classified in Bucket 1 irrespective of credit quality. This includes all originated financial assets measured at amortised cost that fall within IFRS 9, plus those purchased assets within the scope of the standard if there is no explicit expectation of loss.

- The Bucket 1 impairment allowance would capture losses on financial assets expected in the next 12 months (e.g., the 12-month probability of default multiplied by the loss given default).

- The principle of transfer from Bucket 1 to Bucket 2 or 3, i.e., when recognition of lifetime expected losses is appropriate, would be based on fulfilling two criteria: (1) when there has been a more than insignificant deterioration in credit quality since initial recognition; and (2) when the likelihood of default is such that it is at least reasonably possible that the contractual cash flows may not be fully recoverable. The assessment of the transfer will generally be based on the probability of default.

- The impairment approach would be symmetrical, i.e., if there is subsequent improvement in the credit quality of financial assets initially captured in Bucket 1 but that have deteriorated into Bucket 2 or 3, such that either of the two transfer criteria above is no longer met, then these assets would move back into Bucket 1.
The differentiating factor between Bucket 2 and Bucket 3 will be based on the unit of evaluation. When financial assets in Bucket 1 deteriorate in credit quality, these financial assets will move to Bucket 2 when assessed collectively and to Bucket 3 when assessed individually.

Grouping of financial assets for impairment evaluation will be allowed if the financial assets have shared risk characteristics. However, individual assessment will be required if the financial assets have no shared risk characteristics or are individually significant.

Purchased financial assets with an explicit expectation of losses would be classified into Buckets 2 or 3 directly and no movement into Bucket 1 is allowed during their lifetime. No day 1 allowance will be provided as initial loss expectations are recognised in the purchase price and reflected in a credit-adjusted yield. Subsequently, an impairment allowance is recognised based on changes in lifetime expected losses since acquisition.

For trade receivables that have a significant financing component, entities have the choice to apply either the full “three-bucket” approach or a simplified approach that does not require entities to track deterioration but, instead, recognises lifetime expected loss throughout the life of the assets. For trade receivables that do not have a significant financing component, no decision has been made whether to retain the incurred loss approach or apply a simplified expected loss approach.

In assessing whether to recognise lifetime expected losses, entities will need to evaluate all available, reasonable and supportable information including the Boards’ proposed list of forward-looking indicators. This includes both general and specific indicators related to particular types of financial assets.

The Boards have yet to discuss the disclosure requirements and the application to restructured debt, lease receivables, commitments and guarantees.

What does this mean for your organisation?

Leveraging existing models will be complex. Basel II Advanced Internal Rating Based (AIRB) Banks will seek to maximise the use of their existing models, governance and validation process, on the basis that some adjustments will be needed for IFRS 9. For example, IFRS 9 models require the calculation of 12 months and/or lifetime expected losses and must be ‘point-in-time’, using all available, reasonable and supportable information at each period end, whereas AIRB models are based on a different 12 months’ expected loss measurement basis and are usually ‘through-the-cycle’. Leveraging existing Basel models will also require the stripping out of components such as downturn loss given default measures and probability of default floors. This may require new data to be obtained to use within impairment models. In addition, entities will have to ensure that there are robust governance processes and an effective control environment is in place that will deliver rigour in producing expected loss impairment calculations at each period end.

Non-AIRB Banks will need to develop their IFRS impairment models from other credit models or even create new models.

Determining when assets transfer from Bucket 1 to Bucket 2 or 3 is critically important. The threshold for transferring assets from Bucket 1 to Buckets 2 or 3 will play a large part in determining the size of impairment provisions under IFRS 9. It is likely that this will differ from the current triggers for impairment under IAS 39, and will also differ from current definitions of default under Basel II, with loans.
Impairment — assessing the impact of the new proposal

The impact on regulatory capital will attract much attention. For many organisations, the introduction of IFRS 9 will lead to an increase in provisions that could also lead to reductions in core tier 1 regulatory capital under Basel III. This will be of concern to senior management, regulators and investors. Given the sensitivity of the new model to a number of key variables outlined above, organisations should already have started building a clear understanding of the size of change that will be created by IFRS 9. This impact should be communicated with stakeholders. Entities should also be developing appropriate plans for effective implementation of these new complex models.

Tax impact. Depending on the local jurisdiction tax regulations, the change from an incurred to an expected loss model may affect the ability to deduct recorded impairment for tax purposes. In addition, organisations will need to assess the regulatory impact of the increase in provisions on deferred tax assets, the treatment of which is also changing under Basel III.

4. What does your IFRS 9 impairment road map look like?

Expected exposure
draft

Expected final
standard

Capture comparative data for disclosures

Implementation

Key
themes

Assess impact

High level impact assessment
Determine scope for high level simulation
Decide on scenarios and boundary for transfers out of bucket 1
Consider impact of through the cycle or develop point-in-time
Run simulations1 to calculate increase in provision and impact on core tier 1
Benchmark results against peer institutions
Communicate impact to stakeholders and discuss impacts on product development and core tier 1
Use simulations to feedback to IASB and other industry groups
Use simulation results to plan next steps

Detailed impact assessment
Use results of phase 2 work to update scope of impact assessment
Update simulations based on exposure draft
Analyse and agree internally on key modelling aspects, e.g., point-in-time adjustments, calculating lifetime probability of default
Review models, data and governance to establish which models to leverage for IFRS 9 and develop further
Ensure risk/finance reconciliation is robust and includes off balance sheet items
Assess impact on financial reporting processes

Deep dive impact assessment

2012
2013
2014
2015

Adoption

Financial statement impacts

Build roadmap
Based on deep dive impact assessment build roadmap, considering all other IFRS changes and regulatory timetables to manage financial impact

Policies
Make strategic policy choices (e.g., boundaries for transfers out of bucket 1) and accounting policy choices
Review, re-draft and approve new risk and provisioning policies

Concept dry run
Perform dry run of new expected loss model and complete a full assessment of the impacts on the financial statements and regulatory capital
Agree list of refinements and amendments based on lessons learned

Implement the changes across the organisation

Organisation
Choose centralised or decentralised modeling approach
Establish controls over divisions (application of policies, data collection, assumptions and calculations)

Process
Coordinate risk and finance processes (establish single point of coordination with sufficient authority)
Allocate roles and responsibilities (involving risk and finance), review to avoid duplication and control gaps

Data
Perform risk/finance reconciliation to ensure single starting point
Address new data requirements (adjust data models, assign data owners, set up control procedures)

Technology
Ensure system capabilities to collect/store new data, run the models and deliver reports
Consider adoption of a single IT solution (existing or new)

Align with other programs (Basel III and other regulatory reporting); consider impacts on business (product pricing)
Tracking of evolving standards and following industry practices and interpretations
Stakeholder management and communications

Ernst & Young has developed a tool which can help perform such simulations. See the “How Ernst & Young may be able to help” section on the next page.
How Ernst & Young may be able to help

Ernst & Young has an experienced team of accounting, IFRS adoption, credit risk, finance process, tax, and IT professionals that can assist you to assess how the IFRS 9 impairment proposals will affect you and to raise your level of preparedness. In the chart below, we outline the challenges in preparing for the proposed changes and describe how Ernst & Young may be able to help.

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<th>Challenges</th>
<th>How Ernst &amp; Young may be able to help</th>
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| Gain a general understanding of the new or proposed accounting standards. | ▶ Advise you on the key differences from the current IAS 39 provisioning principles  
▶ Design and deliver a training session on the implications of the new proposed standards. The intended audience would be finance, credit risk, capital management and risk and control functions  
▶ Share insights provided by the IASB to the market and industry views, including interpretations                                                                 |
| Estimate the potential impact of the new standard on your current level of provision to prepare for adoption | Advise you on how to:  
▶ Quantify the level of provisions under the proposals using our EY simulation tool. Our tool can demonstrate the impact, by bucket, of the new “three-bucket” approach on the balance sheet with the functionality to drill down to legal entity, business unit and portfolio level to analyse the impacts of adoption on the income statement and on tier 1 capital. Our simulator can easily run several simulations under various scenarios to help gain an understanding of the sensitivity of different portfolios to various parameters in the calculation of expected loss (for example, triggers for transfer to Buckets 2/3). The tool can run useful output reports that can help you discuss the potential impacts of the proposals with senior management |
| Identify key sensitive parameters to the new standard                      | Advise you on how to:  
▶ Perform a data gap analysis in order to identify key missing data (for example lifetime expected loss, expected remaining maturity, rating history since origination)  
▶ Use sensitivity analysis results from the simulations to understand the sensitivity level of the data used  
▶ Address the challenges of the reconciliation between risk and finance data                                                                                           |
| Leverage your current models                                              | Advise you on how to:  
▶ Prepare an inventory of all risk models available by portfolios and their potential use for the new standard  
▶ Prepare suitable strategy for portfolios where no models are available and where existing models will be used  
▶ Prepare the necessary adjustments to be made to the Basel 2 models in order to meet the proposed new IFRS standard (through the cycle vs. point in time, lifetime vs. 1 year probability of default, exclusion of conservatism margins) |
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| Identify and monitor the criteria for transferring from bucket 1 to bucket 2 | Advise you on how to:  
  ▶ Analyse loss history and structure of the portfolios to identify key inflexion points in order to determine the Bucket 2/3 threshold by portfolio (e.g., origination policy, watch list)  
  ▶ Understand how organisations currently calculate and monitor lifetime expected losses  
  ▶ Understand how financial institutions typically calculate lifetime expected loss (market practice) |
| Evaluate the business impacts of the new standard                          | Advise you on how to:  
  ▶ Identify the knock on effects on product pricing (e.g., the extent to which the impact of the new model can be passed on to clients)  
  ▶ Identify the impacts on product structuring, for example the affect on preferred term of loans  
  ▶ Anticipate the impact of the new provisioning method on your credit decisions by portfolio (risk adjusted return on capital (RAROC) or other key performance indicators)  
  ▶ Ensure the business is educated and kept up to speed on developments to allow full and timely analysis of the product impacts |
| Assess the impact on the reporting and disclosures preparation process      | Advise you on how to:  
  ▶ Identify and agree specific changes to entity data collection and reporting processes with local and group management  
  ▶ Understand the new disclosures, management processes, and supporting infrastructure necessary to address the new data challenges  
  ▶ Understand the risks arising from the new calculation process (e.g., due to new models or new data used) and embed them in your current risk framework  
  ▶ Prepare new accounting policies  
  ▶ Understand synergies with other external reports (Pillar 3, for example) |
| Assess the impacts on your current IT architecture                         | Advise you on how to:  
  ▶ Identify and implement changes to supporting IT systems  
  ▶ Understand the additional controls required over the new data |
Contacts

Please contact us if you are interested to discuss further how we can help you understand the impact of the IFRS 9 impairment proposals on your organisation.

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