IFRS changes impacting the banking industry

An update for the CFO
(August 2012)
Now is the time to plan for implementation

Financial institutions reporting under International Financial Reporting Standards (IFRSs) continue to face a steady flow of new standards and interpretations. The volume of changes to IFRS will be substantial over the next three or four years.

The IFRS changes range from some minor modifications to significant amendments of fundamental principles. These changes will affect many different areas of reporting financial information including the introduction of extensive disclosure requirements, the presentation of financial statements, and how particular elements are recognised and measured, such as financial instruments and employee benefits.

The changes will also likely impact the information systems and processes, as well as the regulatory capital of many banks. Furthermore, the changes may impact business decisions, such as which financial products to offer, the creation of joint arrangements or the structuring of particular transactions. The challenge for preparers is to gain an understanding of what lies ahead, evaluate the implications, consider the timing of adoption, and plan for timely implementation of the changes.

This publication provides an overview of both finalised and forthcoming changes in standards that are of particular significance for banks. It is not intended to cover all changes to the IFRSs, nor does it attempt to provide an in-depth analysis or discussion of the topics. Rather, the objective is to highlight key aspects of these changes and the potential impacts. For a summary update on other topics not covered in this publication, refer to EY’s general publication IFRS Update.
Section 1: IFRSs in issue as at 31 August 2012

This section provides a brief update on new standards and amendments to existing standards that are applicable starting from January 2013 or January 2014 and of particular significance for financial institutions:

Balance sheet offsetting

The IASB finished its project on balance sheet offsetting of financial instruments in December 2011 with the issue of amendments to IAS 32 Financial Instruments: Presentation and IFRS 7 Financial Instruments: Disclosures. The IASB decided to retain the existing offsetting criteria in IAS 32. In addition, it also decided to amend some of the application guidance in IAS 32 to address inconsistencies in the interpretation of these criteria with respect to the meaning of “currently has a legally enforceable right to set-off” and the “simultaneous realisation” criterion. Currently, transactions settled through clearing systems are, in most cases, deemed to achieve simultaneous settlement. While many settlement systems are expected to continue to meet the new criteria, some may not. The new disclosures apply not only to all financial instruments that are set off in accordance with IAS 32 but also to financial instruments subject to an enforceable master netting arrangement or similar agreement that are not set-off.

Potential impact

Entities may need to review legal documentation and settlement procedures, including those applied by the central clearing houses they deal with to ensure that offsetting is still appropriate. Any changes in offsetting may impact leverage ratios and regulatory capital requirements.

Entities may need to modify management information systems and related controls to be able to extract the necessary quantitative information to prepare the disclosures. Such changes would need to be implemented immediately to gather the information required for 2012 and 2013. This information will be required for both annual and interim financial statements.

Effective date and transition

The new disclosure requirements for offsetting are to be applied retroactively in the interim/annual financial statements for periods/years commencing on or after 1 January 2013 and the revised offsetting rules are to be applied retroactively in years commencing on or after 1 January 2014.

Consolidation, joint ventures and related disclosures

In 2011, the IASB issued three new standards: IFRS 10 for consolidated financial statements, IFRS 11 for joint arrangements and IFRS 12 for disclosures of interests in other entities.

IFRS 10 establishes a single control model that applies to all entities (including ‘special purpose entities’, or ‘structured entities’). The changes introduced by IFRS 10 will require management to exercise significant judgement to determine which entities are controlled, and therefore, are required to be consolidated by a parent. The IASB has not yet finalised its position on the consolidation by investment companies. The IASB noted that it is important to complete its redeliberations as soon as realistically possible, given the effective date of 1 January 2013 for IFRS 10.

The latest work plan of the IASB states that the ‘target IFRS for investment entities’ is expected in the second half of 2012. Until published, the requirements of IFRS 10 would apply to any entity that is controlled, and hence would continue to be consolidated.

Joint arrangements are now required to be classified as either joint ventures or joint operations as defined in IFRS 11. In joint operations, the joint operator will account for their interests in the arrangements assets and liabilities. In joint ventures, the venturer will now equity account for its interest. The option to account for joint ventures using proportionate consolidation has been removed.

IFRS 12 contains significant new disclosure requirements for both consolidated and certain unconsolidated entities, resulting in significant data challenges.

Potential impact

The most significant impact of IFRS 10 is likely to be felt by the insurance and asset management arms of banks, entities with significant involvement in structured entities, and banks’ loan work-out departments. Key income statement, balance sheet metrics, as well as compliance with regulatory requirements, may be affected if more or fewer entities are consolidated.

New processes and controls will be required to gather the information for the substantial new disclosures related to structured entities required by IFRS 12.

Effective date and transition

The IASB has decided to retain the mandatory effective date of years commencing on/after 1 January 2013, with retroactive application and some limited relief. Early application is permitted,
provided that an entity adopting IFRS 10 or IFRS 11 early also
applies the requirements of IFRS 12, IAS 27 (as revised in 2011)
and IAS 28 (as revised in 2011) at the same time.

In Europe, pursuant to an endorsement advice issued by EFRAG2
in August 2012, the European Commission is expected to defer
the mandatory effective date of IFRS 10, IFRS 11 and IFRS 12 to
1 January 2014 to allow entities more time for implementation.

Fair value
In 2011, the IASB issued a new standard, IFRS 13 Fair Value
Measurement, on how to measure fair value. The standard does not
prescribe when to measure items at fair value. Nor is the standard
solely aimed at financial instruments, but rather applies to all assets
and liabilities that are required to be measured at fair value. The
new definition of fair value is based on an ‘exit price’ notion (i.e., the
price that would be received to sell an asset or paid to transfer a
liability at the measurement date). The standard requires fair value
measurements to maximise the use of observable inputs and
minimise the use of unobservable inputs.

Potential impact
The standard may, among other things, impact the way that
financial institutions take into consideration portfolios of derivatives
with offsetting risks. The standard also requires entities to record an
adjustment to the measurement of derivative liabilities to reflect an
entity’s own default risk.

In addition, the exit price notion in IFRS 13 and the requirement to
maximise the use of observable inputs will require entities to move
to using market-observable credit spreads in the valuations of
derivatives instead of historical entity specific inputs.

Furthermore, new disclosures related to fair value measurements
are required to help users understand the valuation techniques and
inputs used to develop fair value measurements, and the effect of
fair value measurements on profit or loss.

Effective date and transition
IFRS 13 is effective for annual periods beginning on or after
1 January 2013. Early application is permitted.

Post retirement employee benefits
In 2011, the IASB issued amendments to IAS 19 Employee
Benefits. The changes have the following major effects:

- Full balance sheet recognition of pension surpluses and deficits,
  with the optional ‘corridor’ deferral mechanism removed
- Expected returns on plan assets will no longer be recognised
  in profit or loss. Expected returns are replaced by recording
  interest income in profit or loss, which is calculated using the
  discount rate used to measure the pension obligation.
- Actuarial gains and losses will be excluded permanently from
  earnings. Amounts recorded in profit or loss are limited to
current and past service costs, gains and losses on settlements,
and net interest income (expense). All other changes in the
net defined benefit asset (liability) is recognised in OCI with no
subsequent recycling to profit or loss.
- Immediate recognition of past service costs as a result of plan
  amendments.
- The introduction of new or revised disclosure requirements

Potential impact
The amendments will result in greater balance sheet volatility
particularly for those entities currently applying the corridor
approach. Net profit will no longer reflect expected return on plan
assets and no longer include actuarial movements.

Effective date and transition
These amendments are effective for annual periods beginning on
or after 1 January 2013.

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2 European Financial Reporting Advisory Group
The IASB is currently working on a number of projects, some of which are expected to result in exposure drafts or final IFRSs by end of 2012 or 2013. Below, we provide a brief update on certain ongoing projects that are of particular significance for financial institutions:

**Financial instruments: classification and measurement**

This first part of IFRS 9 *Financial Instruments* (finalised in 2009) prescribes, among other things, the conditions under which a financial asset may be measured at amortised cost. Two tests need to be met for amortised cost measurement: the business model test and the characteristics of the asset test. The IASB is currently re-deliberating certain aspects of IFRS 9 with the objective of making limited improvements to its classification and measurement model.

The key proposals made by the IASB to date, are:

i) The introduction of a fair value through other comprehensive income (FVOCI) category for debt instruments. This category would be used for financial assets with contractual cash flows that are solely principal and interest and that are held within a business model which is both: (a) to hold to collect contractual cash flows; and (b) to sell financial assets. The IASB will also provide additional implementation guidance on this category of financial assets.

ii) To slightly amend the characteristics of the asset test to address specific application issues that have been identified in practice.

Following the proposal to introduce a FVOCI category, debt instruments (such as loans and debt securities) would be classified, based on their contractual characteristics and the business model within which they are held, into one of three measurement categories: amortised cost, FVOCI or at fair value through profit or loss (FVTPL).

The proposals are primarily intended to address some application issues and concerns including profit or loss volatility resulting from the interaction of the financial instruments classification and measurement model with the proposed measurement model for insurance contracts.

**Potential impact**

IFRS 9 changes the measurement and presentation of many financial instruments depending on their purpose and nature. These changes will determine whether and when amounts are recognised in net profit. For example:

- Increased profit and loss volatility is expected as more instruments are classified at fair value through profit or loss
- Own credit risk adjustments on financial liabilities designated as at fair value no longer reflected in profit or loss

The proposed introduction of the FVOCI category is of particular significance for many banks in respect of their liquidity ‘buffer’ portfolios held to fund unexpected cash outflows arising from stressed scenarios. Specifically, whether such portfolios would...
now be required to be measured at FVOCI, which, if so, could have a knock on effect on regulatory capital.

The diagram on page 5 charts the new decision tree for debt instruments.

**Project timeline**
The IASB expects to issue an exposure draft for these changes in the fourth quarter of 2012. In light of the timeline set for the ED for this project, we do not expect a final classification and measurement standard before the middle of 2013. This, in addition to the timeline of the impairment phase and insurance project, will continue to put pressure on the mandatory effective date of the final IFRS 9. Specifically, whether 2015 is a feasible date for applying the complete version of IFRS 9.

**Financial instruments: Impairment**
The new ‘expected loss’ impairment model applies to loans and debt instruments measured at amortised cost or at FVOCI. The model is also intended to apply to lease receivables, irrevocable loan commitments and financial guarantee contracts.

The proposed model applies a dual measurement approach that reflects the general pattern of deterioration in credit quality of instruments. When debt instruments (other than those with an explicit expectation of credit losses at inception) are initially recognised, an entity will record 12 months’ expected. This has been defined as the lifetime expected losses for those debt instruments on which a loss event is expected to occur in the next 12 months. Subsequently, when the criteria set out below are met, the 12 months’ expected losses will be replaced by lifetime losses taking into consideration loss events that are expected to occur over the remaining term of the instrument.

The criteria for recording lifetime losses are:

i) When there has been a more than insignificant deterioration in credit quality since initial recognition

ii) When the likelihood of default is such that it is at least reasonably possible that the contractual cash flows may not be fully recoverable

If there is a subsequent movement in the credit quality such that either of the two criteria is no longer met (i.e., credit quality improved) then the expected loss allowance would revert back to 12 months’ expected losses.

An exception applies to purchase or originated debt instruments with an explicit expectation of losses at acquisition or on initial recognition. No day one 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.

A simplified approach is also introduced for certain types of instruments (e.g., trade receivables).

**Convergence**
The joint board meeting in July 2012 highlighted differences in views between the IASB and FASB on the way forward. The IASB proposed developing an exposure draft that would take into account all aspects of the expected loss model. The FASB, however, planned to further consider its application guidance and the feedback received during its outreach activities which highlighted concerns about the understandability, operability and auditability of the proposed model. Subsequently, the FASB directed the staff to explore a single measurement approach that would build on the basic expected loss principle and reflects all credit risks in a portfolio.

The FASB’s decision to explore an alternative approach raises concerns about whether a converged impairment model could be achieved.

**Potential impact**
The effect for most banks that make loans will be to increase the level of provisions significantly. The loan loss expense is also likely to be more volatile as expectations change.

Many banks are currently following the project closely to make sure the proposals can be operationalised without significant cost and effort.

**Project timeline**
Currently, the IASB plans to issue an exposure draft in the fourth quarter of 2012. A final standard is currently scheduled for release in the first half of 2013.

The actual project timing depends on whether the IASB first considers the FASB’s findings or moves forward with a separate exposure draft. If the IASB decides to consider the FASB’s findings, and the boards ultimately agreed on a converged approach, then it is doubtful that a final standard would be achieved by mid 2013, as originally indicated.

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3 US Financial Accounting Standards Board
4 IASB and FASB
Even if the new impairment requirements are finalised before mid 2013, there may not be sufficient lead time for entities to properly implement the requirements before 1 January 2015.

Financial instruments: Hedge accounting

General (or micro) hedge accounting

The new general hedge accounting model focuses on expanding what constitutes a hedging relationship to better match what companies said they do for risk management. Important elements of the model include:

- Re-balancing to continue hedge accounting when the 'hedge ratio' set at the start of the relationship ceases to be effective but the risk management objective is still the same
- Risk components of non-financial items can be designated as a hedged item if 'separately identifiable and reliably measurable' (e.g., the crude oil benchmark ‘component' of jet fuel)
- Aggregated exposures (combinations of derivatives and non-derivatives) would be eligible as hedged items
- Portions or layer components of a nominal amount within fair value hedges may be designated as a hedged item

- Gross positions may be an eligible hedged item if managed on a group basis for risk management purposes and individual items in the group are eligible as hedged items
- A group of forecast transactions resulting in a net position may be an eligible hedged item in a cash flow hedge of foreign exchange risk
- Discontinuation of hedge accounting when either the hedged instrument expires or risk management objectives are no longer met

Potential impact

The new general hedging model is not expected to have a significant impact on the financial reporting of banks. However, corporate entities in particular will now be able to hedge account for many more economic hedging strategies, which may lead to increased focus on product development tailored by banks to meet the new requirements.

Project timeline

A review draft of the final standard for general hedge accounting is expected to be available in September for a review period of 90 days. The IASB is targeting a final standard in the fourth quarter of 2012.
Macro (or portfolio) hedge accounting
The IASB is still developing its macro hedge accounting model. In May 2012, the IASB decided to decouple the macro hedge accounting project from the IFRS 9 Financial Instruments project. As a transitional measure, the Board proposes to carry forward the fair value hedge accounting approach for a portfolio hedge of interest rate risk as set out in IAS 39 Financial Instruments: Recognition and Measurement until the macro hedge accounting project is finalised. It is also the IASB's aim to continue to have the current macro cash flow hedge model available. This will give the IASB more time to develop a macro hedge accounting model without affecting the timing of the completion of IFRS 9.

Project timeline:
An IASB discussion paper on macro hedge accounting is expected in the second half of 2012.

Insurance
In 2010, the IASB issued an exposure draft on how to measure insurance liabilities. The exposure draft required that insurance liabilities need to be measured based on current estimates of future cash flows and current interest rates. The IASB has made several important changes to the ED proposals during its re-deliberations, including the presentation of insurance liability movements due to changes in interest rates in other comprehensive income (OCI).

Potential impact
The exposure draft proposals may have resulted in significant earnings volatility, but the Board has agreed to several changes, including introduction of a fair value through OCI measurement category that is expected to reduce some of the earnings volatility. Profit may be affected by the use of current estimates and volume measures (e.g., premiums) may be overshadowed by summarised earning amounts.

Project timeline
Currently, the IASB plans to issue an exposure draft in the fourth quarter of 2012. A final standard is currently scheduled for release in the first half of 2013.

Leases
After more than 18 months since they had issued their exposure draft on leases, the IASB and FASB tentatively decided at their June 2012 meeting that lessees and lessors would account for leases based on the nature of the asset being leased.

For lessees, all leases with duration of more than 12 months will be recognised on the balance sheet. While many equipment leases would have an accelerated (i.e., front-loaded) lease expense recognition pattern, a lot of real estate leases would have a straight-line lease expense recognition pattern. Lessor would apply operating lease accounting to many real estate leases and a new lessor model known as the “receivable and residual model” to many equipment leases. Under operating lease accounting, the leased property remains on the lessor’s balance sheet and income will be recognised straight-line over the term of the lease. Under the receivable and residual model, lessors will derecognise the portion of the equipment that is leased and instead recognise a lease receivable, measured at the present value of lease payments and recognise the resulting profit. The amount remaining on the lessor’s balance sheet representing the residual asset would be initially measured as the carrying amount of the underlying asset less the cost derecognised.

Potential impact
The proposed model could have a significant impact for the leasing business of financial institutions as the potential impact on the gearing ratios of lessees could result in other forms of financing being more attractive. Structured finance transactions, such as sale and leaseback arrangements with third parties may need to be renegotiated. Furthermore, it would potentially have regulatory capital and governmental levies implications for banks as lessees.

Project timeline
The IASB expects to issue a second exposure draft of its lease project in the fourth quarter of 2012 and a final standard during 2013. The Boards have not made any recent comment on the effective date of the upcoming standard, but they did commit last year to allowing sufficient time for new requirements to be implemented.
Section 3: What is the business impact?

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

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

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

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

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

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

The chart below sets out the mandatory adoption timeline¹ for: (a) Certain new IFRSs and amendments in issue as of 31 August 2012, and (b) Certain ongoing IASB projects which are of particular significance for financial institutions.

The dotted line highlights retrospective application requirements.

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Ongoing IASB projects

| | Mixed transition provisions³ | | |
| | Restated comparative figures³ | | |
| | Restated comparative figures³ | | |

¹ Assumes a calendar year entity.
² Mandatory effective date has not been determined yet, but no earlier than 2015.
³ Transition provisions have not yet been finalised and are subject to change.
⁴ Including interim periods.

Resources
For more details reference can be made to our full suite of IFRS publications which can be found on www.ey.com/IFRS.
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EYG no. AU1238

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