IFRS 9 classification – helping you see more than the tip of the iceberg

EY IFRS 9 Classification Engine (ICE) – making IFRS 9 classification easier, faster, more flexible and more reliable
In order to help you deal with the continuous regulatory and accounting changes in the financial services industry, we created a dedicated Financial Accounting Advisory Services (FAAS) group within EY EMEIA FSO (Financial Services Organisation). We advise financial institutions on new accounting and regulatory standards in banking, insurance and wealth management. Our teams provide insights on matters related to financial accounting and its impact on accounting and reporting processes, systems and controls. Our FAAS group combines technical accounting knowledge with insights from our Assurance, Advisory, Transactions, and Tax departments.

Our experienced people are on top of current market developments in the European and global financial services industry, addressing the most challenging needs of our clients. Our goal is to be the one-stop-shop for CFO’s. In particular, we have knowledgeable consultants in IFRS, Transaction Accounting, Operating Model Simplification, Integrated Risk and Finance Reporting, Solvency II, AnaCredit, Basel III and other requirements mandated by supervising bodies and regulators.

We have major experience in IFRS 9, and our teams across the EMEIA region have successfully provided complete IFRS 9 projects for a significant number of financial institutions.

For IFRS 9 classification and measurement, EY possesses extensive experience in providing tailored tools to its clients.

Introduction

In July 2014, the International Accounting Standards Board (IASB) issued the final version of IFRS 9 Financial Instruments, bringing together the classification and measurement, impairments, and hedge accounting aspects of this IASB project to replace IAS 39 Financial Instruments: Recognition and Measurement.

The new standard, IFRS 9, is effective for annual periods beginning on or after 1 January 2018 for all entities, except for certain insurance entities that are eligible for temporary exemption. These insurance entities can defer the implementation of IFRS 9 until the mandatory date of the upcoming new insurance contracts standard, IFRS 17 (or 2021 if sooner).

Why EY?

We are well prepared to assist all financial services companies. Regardless of whether you are well advanced with your IFRS 9 project, or still anticipating a large effort, we can help you to successfully cross the finish line in time.

The classification of financial instruments under IFRS 9 is based on the entity’s business model for managing the financial assets, but is also based on the nature of their contractual cash flows.

EY has developed the tools needed to facilitate a successful execution of IFRS 9:

- **Our business model checklist** supports a rigorous and structured approach to determining whether cash flows are generated from holding the financial assets, selling the financial assets or both.
- **EY ICE tool** offers an automated classification tool for instruments with identifiers (ISIN, CUSIP). This tool has repeatedly demonstrated its value during our client engagements throughout the globe. EY ICE tool has benefited from the rich input that our clients and our senior leadership have provided during its development and is continuously updated.
- In order to analyse more complex loans and contractually linked instruments that are not eligible for automated classification, we offer a **text data mining tool**, which generates an assessment of the instruments’ risk of failing the contractual cash flow (SPPI - Solely payments of principal and interest) test.
- The results of this assessment can then be used as a basis for further classification using our **SPPI checklist**. This checklist examines all essential instrument features that are relevant for classification.
Key aspects of the IFRS 9 classification for financial assets

This chart provides an overview of the required assessments and resulting outcomes for IFRS 9 classification and measurement.

**Debt** (including hybrid contracts)

- **‘Business model’ (BM) assessment** (at an aggregate level)
  - (1) Hold-to-collect contractual cash flows
  - (2) BM with objective that results in collecting contractual cash flows and selling financial assets
  - Neither (1) nor (2)

**Conditional fair value option (FVO) elected?**

- Yes
- **No**
  - Amortised cost
  - FVOCI* (with recycling)

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**Derivatives**

- **‘Contractual cash flow characteristics’ test** (at instrument level)
  - Pass
  - Fail
  - Fail
  - Fail

**Equity**

- **Held for trading?**
  - No
  - Yes

- **FVOCI option elected?**
  - No
  - Yes

- **FVOCI**
  - (no recycling)

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*FVOCI: Fair Value through Other Comprehensive Income
**FVTPL: Fair Value through Profit or Loss
EY IFRS 9 classification methodology and related tools

EY has developed a wide range of tools for efficient IFRS 9 classification, covering all aspects of the required assessment.

Among them is the EY ICE tool, which performs automated classification of portfolios consisting of securities with an ISIN or CUSIP.

Business model testing

The business model reflects how a portfolio of assets is managed to achieve business objectives, whether by holding the financial assets, selling the assets or both. Management needs to use judgment to assess the business model, taking all factors and activities into account. Sufficient evidence is required in order to reach the right conclusions, which underlines the need for a structured approach. EY will guide the entity through the assessment procedure and assist management in covering key aspects.

SPPI testing

For a debt instrument to pass the contractual cash flows characteristic test and be subsequently measured at amortised cost, or fair value through other comprehensive income, the entity must determine whether contractual cash flows are ‘solely payments of principal and interest’. Hence, the assessment is also referred to as the ‘SPPI test’. An instrument passes the SPPI test if it does not introduce risks or volatility that are inconsistent with a basic lending arrangement.

The SPPI testing typically involves a fair amount of resources, and many entities underestimate the efforts required. EY SPPI testing tools will facilitate this process while substantially reducing the time and costs related to this work.

The following chapters will describe four tools in more detail:

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What to expect

Purpose

IFRS 9 requires the business model assessment to be based on the facts and circumstances that exist on the date of adoption of the standard. Our business model checklist provides the necessary support to perform this assessment, and helps to unravel important information regarding how financial assets are managed by the entity. As the business model assessment is an area of the standard requiring considerable judgment, it is imperative that entities use a structured approach.

Requirements

In order to be able to help you, we would need to conduct interviews with the relevant contacts in your organisation. These are professionals who know the financial instruments, and are a vital source of information for performing the assessment. The checklist includes an analysis of key performance indicators the entity uses to assess performance, an overview of business objectives and a quantitative analysis of sales levels.

How it works

The tool consists of a filled out detailed Word document with an Excel-based template embedded. When completed, the checklist itself is the output.

Key features

- A standardised question list continuously adapted on the basis of our experience from other projects is provided.
- The output satisfies the documentation requirements imposed by the standard.
Automated classification – EY ICE

What to expect

Purpose

For the SPPI testing of instruments with an identifier (ISIN, CUSIP), EY presents EY ICE tool (IFRS 9 Classification Engine), our tool for automated classification. It can be used to reliably and accurately analyse instruments on the basis of key characteristics. The tool retrieves market data and accurately classifies the instruments using an IFRS 9-based decision tree algorithm.

Requirements

An identifier is needed for each instrument (ISIN, CUSIP, etc.).

How it works

The tool retrieves market data from data providers on the basis of the identifier. Through the use of a decision tree algorithm that is built on IFRS 9 principles, it accurately classifies financial instruments, significantly reducing the resource requirements compared to manual classification. The tool classifies the instruments using an IFRS 9-based decision tree algorithm, combining IFRS 9 principles with EY interpretations that are based on our vast market experience. Indicators of the fair value are flagged, and the tool gives a highly detailed output including visuals and an audit trail.

• Fast: The data extraction and classification report generation is done within a few hours.
• Easy: The only input needed is a list of ISIN (or CUSIP) codes, then the tool produces an excel file indicating the classification conclusion and the reasons for it.
• Reliable: The tool is validated by our senior leadership and used for many Financial Institutions in the world. The results and related documentation include a detailed audit trail.
Key features

EY ICE tool significantly reduces required classification efforts, offers a consistent approach and improves accuracy.

Clients typically achieve a portfolio coverage of 90% when using the tool.

SPPI testing performed with EY ICE tool typically results in a portfolio coverage of about 90%, but other key benefits arise as well. By using this tool, we can:

- Significantly reduce the required effort for SPPI testing given the high degree of automation
- Offer the same consistent approach for every financial instrument
- Provide details on the classification process for each instrument with reference to the standard

Why is this tool special?

- Detailed output and audit trail including rationale for classification
- In use since 2011 and continuously updated
- Highly flexible rule engine
- Flexibility regarding input: classification of any identifier supported by data providers

For all of the ISINs that were not classified by the tool, we have a database of financial instruments that have been assessed manually by EY.
What to expect

Purpose
This tool is used in order to perform an assessment of the financial instruments’ risk of failing the contractual cash flow (SPPI) test. The tool can be used for any instrument with a text contract. This includes contractually linked instruments (asset backed securities), loans and mortgage contracts.

Requirements
For contractually linked instruments, the Offering Memorandum (also known as Offering Circular or Prospectus) is needed. For loans and mortgages, the contract is required.

How it works

- The tool performs a keyword search using a lexicon of keywords.
- Each keyword has an associated risk weight.
- The keyword lexicon is different for loans and CLIs.
- Extending the lexicon is an iterative process.
Key features

Our automated tool creates a user-friendly classification output and highlights instruments that need further analysis.

Our text data mining tool offers you a very efficient way of dealing with vast volumes of text:

- The current engine can assess a 600kb contract with about one million characters in 0.03 seconds.
- The tool can process a dataset of 600Mb and numbering of 1,000 contracts, in about 30 seconds (benchmarked).
- It can manage the population of 100,000 contracts, with 60Gb total size, in under one hour (untested).
- These results can be improved with faster hardware.

The lexicon in our tool has been developed over years of experience and has the functionality to assess contracts in different languages.

The output of the tool highlights the instruments that need further analysis:

- Risk matrix shows risk of FVTPPL classification within risk categories.
- Risk class produces buckets of instruments that may be further investigated as necessary using the SPPI checklist.

Text data mining tool
The challenge – CLIs (securitisations)

<table>
<thead>
<tr>
<th>Question</th>
<th>EY ICE tool and text data mining</th>
<th>EY ICE tool</th>
<th>Text data mining tool</th>
<th>Text data mining tool</th>
<th>Credit risk “tranche vs. pool” test*</th>
<th>Text data mining tool</th>
<th>Pass SPPI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Is it practicable to look through to the underlying pool of instruments?</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Fail SPPI</td>
</tr>
<tr>
<td>Does the tranche have cash flows that are solely payments of principal and interest?</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Fail SPPI</td>
</tr>
<tr>
<td>Does the underlying pool have instruments with cash flows that are solely payments of principal and interest?</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Fail SPPI</td>
</tr>
<tr>
<td>Do all other instruments in the underlying pool reduce cash flow variability or align the cash flows of the tranches with the cash flows of the underlying pool?</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Fail SPPI</td>
</tr>
<tr>
<td>Is the credit risk of the tranche equal to or lower than the credit risk of the underlying pool of instruments?</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Fail SPPI</td>
</tr>
<tr>
<td>Can instruments in the underlying pool change after initial recognition, in a way the pool does not meet the conditions above?</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Fail SPPI</td>
</tr>
</tbody>
</table>

* EY created a dedicated methodology for efficient “tranche vs pool” testing, on the basis of the input from external market data and credit rating providers.
Key benefits

- Suitable for all assets including CLIs
- Covers every important issue described in the standard
- Considers completeness and exceptions
- Easy to understand with explanations and examples
- Output given as a clear ‘pass’ or ‘fail’ based on every relevant SPPI criterion
Your EY contacts

For more information and an approach tailored to your needs, please contact our IFRS 9 team.

**EY EMEIA contacts**

<table>
<thead>
<tr>
<th>Country</th>
<th>Contact</th>
<th>Email</th>
<th>Phone</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>Emmanuel Villaire</td>
<td><a href="mailto:emmanuel.villaire@be.ey.com">emmanuel.villaire@be.ey.com</a></td>
<td>+32 474 845 067</td>
</tr>
<tr>
<td>France</td>
<td>Celine Molinari</td>
<td><a href="mailto:celine.molinari@fr.ey.com">celine.molinari@fr.ey.com</a></td>
<td>+33 1 46 93 46 44</td>
</tr>
<tr>
<td>Germany</td>
<td>Thimo Worthmann</td>
<td><a href="mailto:thimo.worthmann@de.ey.com">thimo.worthmann@de.ey.com</a></td>
<td>+49 89 14331 15507</td>
</tr>
<tr>
<td>Italy</td>
<td>Francesca Amatimaggio</td>
<td><a href="mailto:francesca.amatimaggio@it.ey.com">francesca.amatimaggio@it.ey.com</a></td>
<td>+39 02722122035</td>
</tr>
<tr>
<td>Netherlands</td>
<td>Sander de Ruiter</td>
<td><a href="mailto:sander.de.ruiter@nl.ey.com">sander.de.ruiter@nl.ey.com</a></td>
<td>+31629083992</td>
</tr>
<tr>
<td>Spain</td>
<td>Randolf Niedermeyer</td>
<td><a href="mailto:randolf.niedermeyer@es.ey.com">randolf.niedermeyer@es.ey.com</a></td>
<td>+34933748132</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>Yolaine Kermarrec</td>
<td><a href="mailto:yolaine.kermarrec1@uk.ey.com">yolaine.kermarrec1@uk.ey.com</a></td>
<td>+44 7982 622 206</td>
</tr>
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EY is a leader in serving the financial services industry
We understand the importance of asking great questions. It’s how you innovate, transform and achieve a better working world. One that benefits our clients, our people and our communities. Finance fuels our lives. No other sector can touch so many people or shape so many futures. That’s why globally we employ 26,000 people who focus on financial services and nothing else. Our connected financial services teams are dedicated to providing assurance, tax, transaction and advisory services to the banking and capital markets, insurance, and wealth and asset management sectors. It’s our global connectivity and local knowledge that ensures we deliver the insights and quality services to help build trust and confidence in the capital markets and in economies the world over. By connecting people with the right mix of knowledge and insight, we are able to ask great questions. The better the question. The better the answer. The better the world works.

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