IFRS 9 in a box

EY IFRS 9 recommendations for small-and medium-sized entities
Executive summary

1. Background

- The International Accounting Standards Board (IASB) has issued the final version of IFRS 9 that incorporates new regulation on the accounting for financial instruments. The main requirements are:
  - Classification and measurement of financial instruments depending on two assessments:
    - Their contractual cash flows
    - The entity’s business models
  - Impairments, on the basis of either 12-month or lifetime expected credit losses (ECLs), depending particularly on whether there has been a significant increase in credit risk since initial recognition
  - Extensive notes disclosures (IFRS 7 Financial Instruments : Disclosures)

- With EU endorsement completed on 22 November 2016, the mandatory date of initial adoption will be 1 January 2018. For smaller-and medium-sized banks (SME) that are just starting their execution projects, the remaining time until initial adoption poses a significant challenge and risk of noncompliance.

- On the basis of our various project experiences and tools, EY has developed “IFRS 9 in a box” recommendations to facilitate a goal-oriented and quality confirmed execution of IFRS 9 for our smaller-medium-sized clients in time for 1 January 2018.

2. Three steps of the “IFRS 9 in a box” approach

- Our IFRS 9 in a box approach covers three phases:
  - A quick scan phase where we obtain high-level understanding of the areas impacted by IFRS 9
  - An assessment to perform a focused gap analysis and identify different execution options
  - An execution phase to apply the chosen approach and become IFRS 9-compliant

Each phase of our IFRS 9 in a box-tools facilitates the IFRS 9 implementation.

On the basis of our experience, the IFRS 9 in a box approach allows smaller-medium-sized clients to implement IFRS 9 in less than one year, depending on individual complexities and available resources.

3. Why EY

- Our Financial Services (FS) are an integrated area that includes many professionals and IFRS 9 experts across many countries (UK, Germany, France, India and many more) and collaborates across competencies (Advisory, Assurance, Tax and Transaction Advisory).

- EY has been engaged by many global banks for accounting change projects on a group-wide basis. We thus understand the complexities, challenges and opportunities of implementing IFRS across multiple geographies, business units and diverse portfolios.

- We are one of the market-leading for IFRS advisory execution services with a strong focus on IFRS 9 end-to-end execution projects.

- We have extensive IFRS 9 project experience and knowledge of key accounting and project decisions to be taken to allow timely and robust IFRS 9 execution.

- In addition, we have developed several IFRS 9 tools and enablers on all key challenges, such as project management, solely payments of principal and interest (SPPI) test and impairment calculations.

- Experience helps us to serve our smaller-medium-sized clients on their IFRS 9 execution projects.

EY is the market leader for IFRS 9 end-to-end execution projects

Our IFRS 9 in a box-capability enables IFRS 9-implementation within a few months
Overview of IFRS 9 classification and measurement

Key challenges of IFRS 9 execution

Overview of technical requirements

► The basic consideration is that the amortized cost (AC) measurement is only permitted if:
  ► The business model is “hold to collect”.
  ► The contractual cash flows are solely payments of principal and interest.
► The measurement of all other kinds of financial instruments is at fair value.
► In case of Fair Value measurement, debt instruments are measured at fair value through other comprehensive income (FVTOCI) if their business model is both, to hold and sell the instruments.
► Derivatives have to be recognized at fair value through profit or loss fair value through profit or loss (FVTPL).

With the use of IFRS 9 in a box, we support the efficient and comprehensive execution of IFRS 9 classification and measurement. By using a standardized method developed for SMEs, the following advantages can be realized:

► Quickly understand the requirements from IFRS 9 CRM
► Easy identification of key challenges and impacts on your entity (e.g., automated SPPI analysis)
► Benefit from proven solution (e.g., cluster concepts)
► Tailored recommendations for SMEs-clients (e.g., portfolio-based recommendations)
Overview IFRS 9 impairment

Key challenges of IFRS 9 execution

Overview of technical requirements

- Compared to the existing incurred loss model, the new expected loss model results in a change from a backward-looking, rules-based, and heterogeneous approach for particular groups of financial instruments to a forward-looking, principles-based and homogeneous approach for all kinds of financial instruments.
- The basic consideration is, that expected losses are already considered during the initial recognition of a financial instrument (turning away from the current IAS 39 incurred loss model).
- All amortized cost and FVTOCI debt financial instruments as well as off-balance items are subject to IFRS 9 Impairment.
- The amount of impairment is determined in a three stages approach according to changes in credit quality.
- IFRS 9 execution should be planned early to control transition effects.

Key challenges

- Definition of transfer criteria for stage assignment.
- Conceptual design of a calculation method including IFRS 9-compliant credit risk parameters.
- Impacts on the IT infrastructure of the entire organization.
- Process-related integration in financial statement closing process and regulatory reporting process.
- Reconsider your underwriting criteria to achieve desired impairment results.

IFRS 9 in a box provides approaches that are perfectly tailored for approach SMEs clients, considering all IFRS 9 impairment related aspects with the use of robust and powerful EY tools. This allows you to benefit from the following:

- Quickly understand the requirements from IFRS 9 impairment.
- Easy identification of key challenges and impacts for your entity (e.g., quantitative impact analysis).
- Benefit from proven solutions (e.g., simplified ECL modeling).
- Tailored approaches for SME clients (e.g., loss rate-approach).
Three-step approach toward IFRS 9 implementation

IFRS 9 in a box – EY recommendations for small-medium-sized banks

Our IFRS 9 in a box approach has three distinct phases to allow a quick but robust execution of IFRS 9. This approach has been widely tested in practice and is built on quality assured project experiences. Key success factors are transparency of project progress, quick accounting and project decisions as well as an in depth understanding of conceptual and technical interactions.

1. Quick scan
   - High level understanding of the individual key challenges from IFRS 9
   - Quick scan of business model
   - Quick scan of group structure
   - Quick scan of operations, processes and controls
   - Quick scan of architecture
   - Discuss financial and business planning regarding IFRS 9 impacts
   - Discuss desired operational setup following 1/1/2018
   - Mobilize

2. Focused GAP analysis and recommendation design
   - Identify key action points based on a focused GAP analysis
   - Conduct GAP analysis focused on the key issues from step 1
   - Design recommendations based on GAPs identified and desired setup identified in step 1
   - Decide on usage of EY tools
   - Formulate key action points to close action points
   - Facilitate high quality decisions and overall transparency

3. Execution
   - Conduct robust closing of GAPs based on quality assured benchmark recommendations
   - Provide on action points identified
   - Apply IFRS 9 in a box approach for classification and measurement and impairment
   - Test and deploy
   - Parallel run
   - Go live

Our IFRS 9 in a box approach combines our comprehensive project experiences within a single, standardized IFRS 9 recommendation for small- and medium sized banks. This approach helps our clients to implement IFRS 9 efficiently by 2018. The advantages are twofold:

1. Excellent quality based on various IFRS 9 project experiences
2. Focused and cost efficient execution of IFRS 9

Our approach consists of two separate boxes – a classification and measurement box and an impairment box, which together ensure the required compliance with the standard. To reduce costs and simplify the process, we will provide you with the most up to date tools and enablers, developed and designed by EY.
Proven methodology and powerful tools

IFRS 9 in a box – EY recommendations for small-medium-sized banks

Our approach

Efficient recommendation

► Pre-written drafts for technical concepts that have to be customized for the clients’ needs
► Use of EY-automated classification tool for initial SPPI-assessment and IFRS 9 SPPI checklist for manual analysis
► EY IFRS 9 LIC Solution as a powerful tool to measure and report IFRS 9 ECLs

Key understandings:
► IFRS 9 in a box has been set up as a comprehensive solution to implement IFRS 9 for small- and medium-sized clients.
► The value added of the concept relies on simplified recommendations for the SPPI analysis, impairment and the technical concepts in the execution.
► To simplify the processes and still be able to cope with all the requirements of the standard, it is necessary to build tools and enablers that minimize the remaining work.

Our IFRS 9 in a box approach focuses on the essentials containing clear statements in respect to procedural and technical actions. These were supported by our proven, as well as already in project-used tools and accelerators which can be suited to the clients’ requirements.
Classification and measurement in a box

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Examples of SPPI-challenges

- Debt instruments with inverse returns (inverse floaters), i.e., “5% – 3M EURIBOR”
- Debt instruments with a tenor-frequency-mismatch (i.e., interest rate on the basis of 6M-EURIBOR with a fixing frequency of 3M)
- Junior tranche of a contractually linked instrument, i.e., ABS
- Convertible bonds, i.e., debt instruments with share options
- Debt instruments with embedded leverage component (i.e., return is twice the 6M EURIBOR)
- Steepening products (i.e., return is the difference between the 10y-EUR-swap rate and the 1y-EUR-swap rate)
- Dual currency bonds with different currencies for principal and interest
- Debt instruments with prepayment options and a disproportionate compensation for the early settlement
Impairment in a box

**IFRS 9 in a box – EY recommendations for small-medium-sized banks**

Our **IFRS 9 in a box** approach is based on our experience from IFRS 9 impairment projects. It is designed to cover all IFRS 9 impairment requirements, including current industry developments and discussions in the professional bodies. Since IFRS 9 application depends on the size and the complexity of the entity, we have developed a sophisticated benchmark approach, as well as a simpler approach that might be suitable for small and medium-sized banks.

### Sophisticated approach

<table>
<thead>
<tr>
<th>ECL methodology</th>
<th>Simpler approach</th>
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<tbody>
<tr>
<td><img src="image1" alt="Term-to-maturity approach" /></td>
<td><img src="image2" alt="Term-to-maturity approach" /></td>
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<tr>
<td><img src="image3" alt="Loss-rate approach" /></td>
<td><img src="image4" alt="Loss-rate approach" /></td>
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<tr>
<td><img src="image5" alt="Segment parameters" /></td>
<td><img src="image6" alt="Segment parameters" /></td>
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<thead>
<tr>
<th>Default definition</th>
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<tbody>
<tr>
<td><img src="image7" alt="Consistent single definition for regulatory and financial reporting" /></td>
<td><img src="image8" alt="Use regulatory models without amending definition of default and adjust output" /></td>
</tr>
<tr>
<td><img src="image9" alt="Uniform application in all aspects of ECL" /></td>
<td><img src="image10" alt="If the difference of the output is believed to be immaterial, install processes and controls in support of this view" /></td>
</tr>
<tr>
<td><img src="image11" alt="Reflect different characteristics of FI" /></td>
<td><img src="image12" alt="Processes for updating the definition" /></td>
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<tr>
<th>Probability of default (PD)</th>
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<tbody>
<tr>
<td><img src="image13" alt="Twelve-month PD (adjust internal ratings based models where available or develop new models)" /></td>
<td><img src="image14" alt="Simplified 12-month PD calculation (internal benchmarking, external rating and simpler alternatives)" /></td>
</tr>
<tr>
<td><img src="image15" alt="Lifetime PD (develop 12-month PD or develop a new model)" /></td>
<td><img src="image16" alt="Simplified extrapolation approach for lifetime PD" /></td>
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<tr>
<th>Exposure at default (EAD)</th>
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<tr>
<td><img src="image17" alt="Reflects expected changes in the balance outstanding over the lifetime of the loan" /></td>
<td><img src="image18" alt="Approximation of the current 12-month EAD as proxy for EAD remaining life" /></td>
</tr>
<tr>
<td><img src="image19" alt="Differentiated models for different portfolios" /></td>
<td><img src="image20" alt="Use of segmented credit conversion factor (CCF) models" /></td>
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<tr>
<td><img src="image21" alt="Fewer levels of risk segmentation" /></td>
<td><img src="image22" alt="Use portfolio averages for some components" /></td>
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<tr>
<th>Loss given default (LGD)</th>
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<tr>
<td><img src="image23" alt="Common LGD methodology applied consistently" /></td>
<td><img src="image24" alt="Less depth of analysis when estimating the impact of macroeconomic dependency" /></td>
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<tr>
<td><img src="image25" alt="Specific requirements for components in the approach" /></td>
<td><img src="image26" alt="Data histories used to support the analysis may be shorter" /></td>
</tr>
<tr>
<td><img src="image27" alt="The estimates consider specific dependencies and correlations" /></td>
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*IFRS 9 in a box*
# Impairment in a box

## IFRS 9 in a box – EY recommendations for small-medium-sized banks

### Sophisticated approach

<table>
<thead>
<tr>
<th>Discounting</th>
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<tbody>
<tr>
<td>▶ ECLs calculated by estimating timing of expected cash shortfalls and discounting them</td>
</tr>
<tr>
<td>▶ Discount rate is the effective interest rate</td>
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<thead>
<tr>
<th>Staging assessment</th>
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<tr>
<td>▶ The quantitative element is the primary indicator of significant increases in credit risk and is calculated based on the change in lifetime PDs</td>
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<tr>
<td>▶ The credit risk has increased significantly if the contractual payments are due more than 30 days (rebuttable presumption)</td>
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<table>
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<tr>
<th>Macro-economic forecasts and forward-looking information</th>
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<tr>
<td>▶ Sometimes more than one scenario is required</td>
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<tr>
<td>▶ The sophisticated approach requires several features of the scenarios in place</td>
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### Simpler approach

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<table>
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<tbody>
<tr>
<td>▶ Time value of money reflect in ECL calculation using estimated portfolio average collection periods</td>
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<tbody>
<tr>
<td>▶ The qualitative assessment will play a more significant role</td>
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<tr>
<td>▶ For the quantitative element, it may be possible to use changes in 12-month PDs, rather than lifetime PDs</td>
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<tr>
<td>▶ The level of detail used in addressing each principle may be proportionately less for a simpler approach</td>
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<tr>
<td>▶ A bank may be able to perform a simpler analysis of historical relationships between observed defaults</td>
</tr>
</tbody>
</table>

### Examples of what is not compliant

- Fair value models to estimate ECLs without appropriately adjusting for changes in market rates of interest and yields
- Using expected losses calculated for regulatory purposes, without assessing if any adjustments are required to reflect IFRS 9 requirements
- Excluding the effects of contractual repayments and expected prepayments on loans, and expected drawdowns on committed facilities
- Using the definition of default when modelling probability of default for IFRS 9 purposes that results in fewer default events being captured than are actually monitored and observed
- Using information designed for regulatory purposes without assessing whether any adjustments are required for the information to be fit for use under IFRS 9
- Not applying 90 days past due backstop unless there is documented reasonable and supportable information as to why it is not appropriate
- Using 12 months EADs as a proxy for a lifetime of EADs without appropriate justification
- Continuing to use IAS 39 EIR approximations without assessing if appropriate for purposes of IFRS 9
- Not reflecting time value of money in ECL/discount rates not suitably approximate EIR of the portfolio
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