EY IFRS 9 Classification & Measurement banking survey

December 2017

Building a better working world

IFRS 9 Financial Instruments: the remaining complexity of C&M

As we move closer to the adoption of *International Financial Reporting Standards (IFRS) 9 Financial Instruments* on 1 January 2018 there is a heightened focus on IFRS 9 Classification and Measurement (C&M).

Although the impact of C&M was expected to be less significant compared to impairment, banks have been focused on addressing requests from regulators, auditors and other stakeholders to demonstrate this with documented evidence.

With less than one month to go, banks have become aware that despite limited quantitative impacts, the new C&M requirements pose significant challenges in terms of management judgement and increased complexity of key processes such as the granting of loans and new product development processes.

In April 2017, EY performed an IFRS 9 C&M survey of 60 banking institutions globally. The survey was undertaken to assess the "state of readiness" in the implementation of their IFRS 9 with a particular focus on C&M. This paper outlines the survey results, including the expected reclassifications of IFRS 9, key operating model and policy decisions, and the assessment of business impacts. All results are presented on an anonymous basis.

For further insights on IFRS 9, including how your institution is compared with others in the survey, please contact our survey team given in the appendix to this survey or your local EY contact.

We very much hope you find this document helpful as you continue your IFRS 9 implementation.

December 2017
Francesca Amatimaggio
EY Partner

Participants' profile

We surveyed 60 major banking institutions worldwide, of which:

- 19 have a balance sheet in excess of €600b (hereafter considered "large banks")
- 12 have a balance sheet between €200b and €600b (hereafter considered "mid banks")
- 29 have a balance sheet of less than €200b (hereafter considered "small banks")

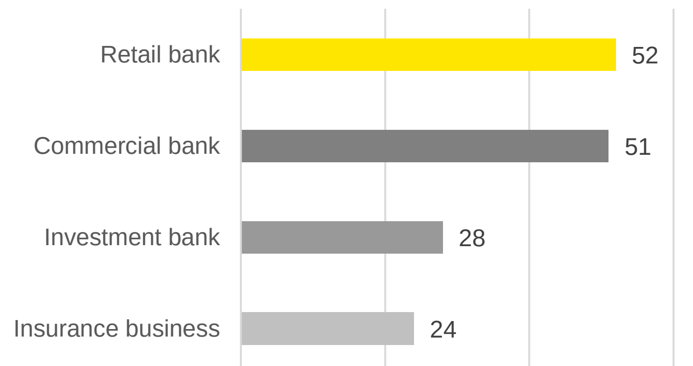
Of the 60 banks:

- 14 are global systemically important banks (G-SIBs)
- 18 are in the scope of the Sarbanes-Oxley Act (SOX)

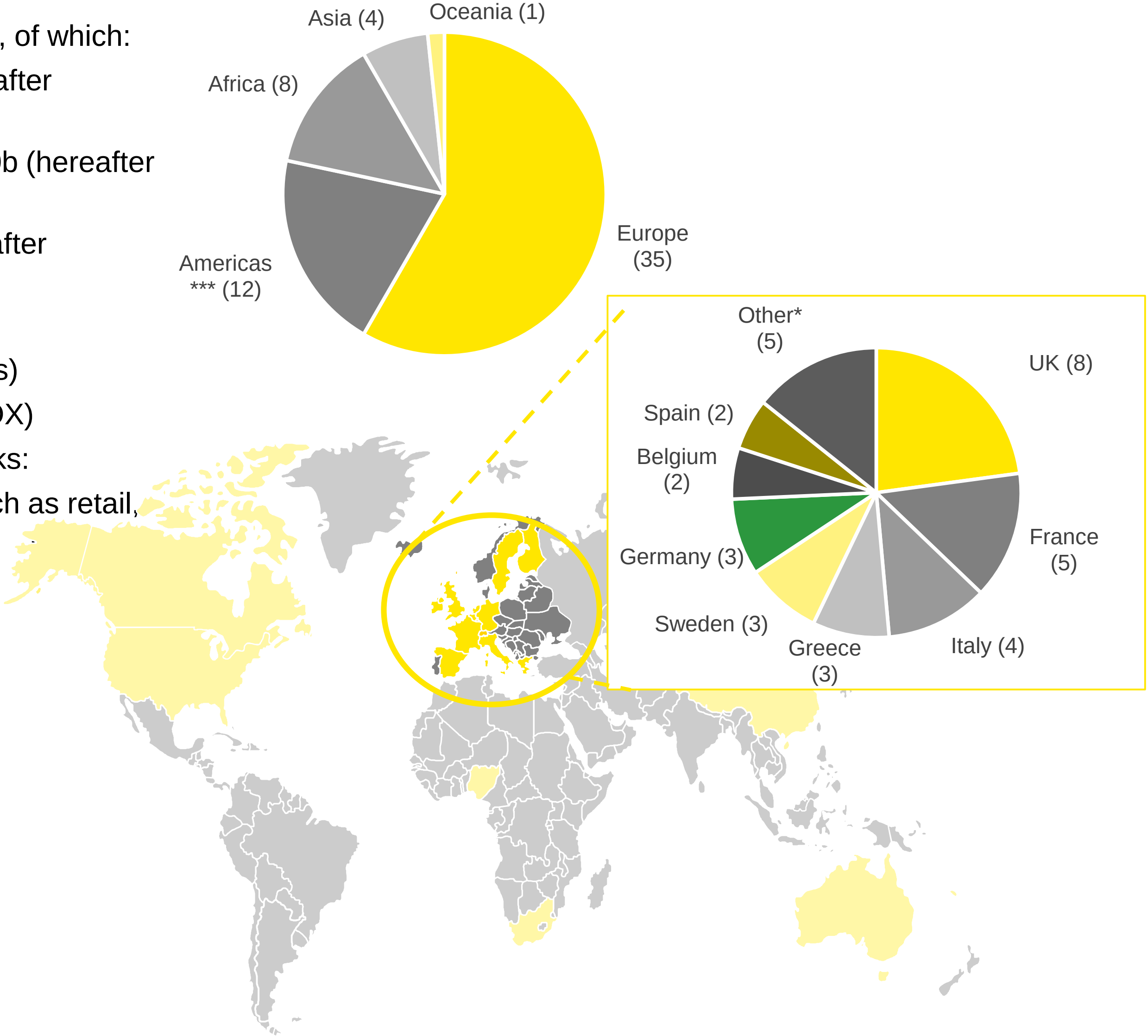
Considering the business profile of the surveyed banks:

- 19 participants operate in all banking activities, such as retail, commercial and investment banking, plus insurance business
- 12 participants operate in one banking sector only

Banking activities**



Geographic segmentation of participants



*Other includes (one respondent each): Finland, Ireland, Luxembourg, Netherlands and Switzerland.
** The total is more than 60 as most banks selected more than one option.
*** Americas includes US overseas subsidiaries and Canadian banks.

EY IFRS 9 Classification & Measurement banking survey at a glance

Limited reclassifications overall

Out of the limited value reclassified

Almost

45%* **is toward FVPL, and relates**

to reclassification from loans and receivables (L&R), held to maturity (HTM), available for sale (AFS) debt instruments to fair value through profit or loss (FVPL).

SPPI impacts: main trigger for reclassifications to FVPL

Almost

65% of banks say that

reclassifications to FVPL are solely due to the SPPI test.

Wide ranges of degree of preparation, correlated with the size of the banks

More than

55%

of banks haven't reached the implementation phase for

Data & systems, and

Operating model

Only two banks are actually complete for data and systems and operating model.

Changes in the approval process

Approximately

55%

of banks are considering a revised framework for new products.

Budget significantly lower than that for impairment

C&M budget is lower than

€5m

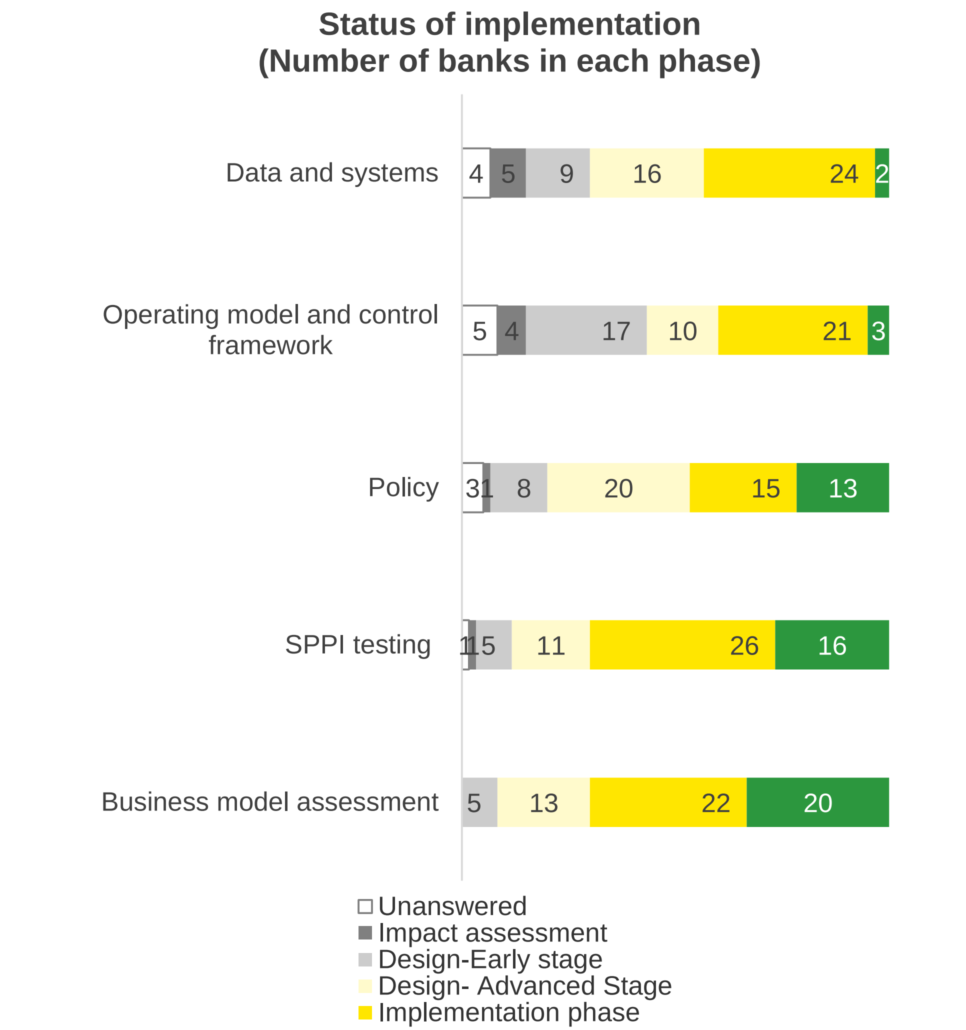
For two-thirds of the banks.

*45% out of the reclassifications made is the result of: 2% from HTM, 20% from L&R, 23% from AFS.

Contents

1. IFRS 9 project status
Overall state of readiness

Data



Commentary

Most advanced phases are solely payments of principal and interest (SPPI) and business model (BM) assessments

- Regarding data and systems, operating models, and policy, more than half of the sample has not reached the "Implementation" status.
- Very few banks have reached a "Complete" status on data and systems and operating models.

Wide ranges of degree of preparation

- Larger banks are more advanced for all phases:
  - At least 50% of them have reached the implementation phase for all the phases.
  - Regarding SPPI and BM assessments, 95% and 80% of respondents have reached the implementation phases respectively.
- Small banks are less advanced: only 30% of them have reached the Implementation for all the phases (50% of them for SPPI and BM assessments only).

Asian* and European banks are further advanced with the implementation

- The geographical distribution of answers shows that Asian* banks are at an advanced stage of completion, with two respondents confirming that all the aspects have been completed.
- European banks on an average revealed an advanced stage of implementation, but with a wide range of results.

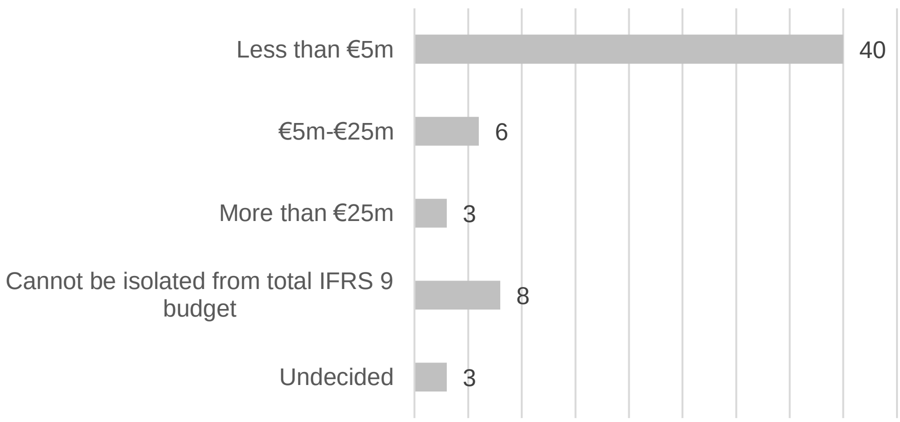
Finally, the overall state of readiness is also influenced by the expected budget, as banks with the larger C&M budgets are more advanced with their programs

* Data collected from the Australian bank have been included in the Asian cluster for geographical breakdown to keep confidentiality due to the number of participants. Furthermore non-responses have been removed from the cumulative count.

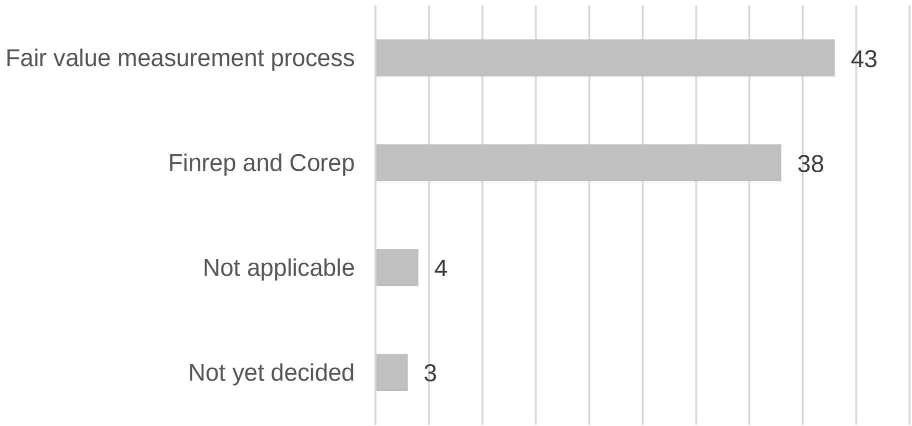
1. IFRS 9 project status
Budget and synergies

Data

Expected total budget for C&M



Interactions with other internal process*



Commentary

The budget for C&M seems to be relatively small compared the total IFRS 9 budget

- The total budget (including Impairment) is more than 5m € for almost 80% of the respondents, whereas the C&M-only budget is more for only less than 25% of the respondents.
- Respondents show some uncertainty regarding the cost of implementation of the new requirements, with nearly 20% of banks not able to quantify the expected total budget for C&M (based on the responses "Cannot be isolated from total IFRS 9 budget" and "Undecided").

Cost estimates related to size and type of business

- As expected, larger and more complex banks are spending more than smaller one-activity-focused banks.
- A few American participants reported to have a large part of their IFRS balance sheets at FVPL, and this remains the case under IFRS 9. Their IFRS 9 project effort and budget is therefore focused on C&M documentation.

Most banks see interactions between C&M and other internal processes

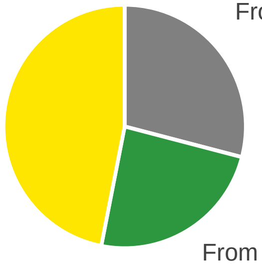
- Fair value measurement processes: Banks are dealing with the need to calculate fair values for non-SPPI loan products and unquoted equity instruments currently measured at cost.
- Finrep and Corep: C&M workstreams are developing integrated processes with regulatory requirements for reporting (also *Liquidity Coverage Ratio*) and disclosure.
- New product approval processes are being updated to incorporate the SPPI testing at the time of product development.
- *Fundamental Review of the Trading Book* programs: Banks are exploring the interplay between classification and the boundary between banking and trading books.

* The total is more than 60 as some banks selected more than one option.

2. Impact assessment
Change in measurement and accounting categories

Data

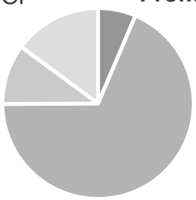
Change in measurement basis
(Assets value transferred out of the reclassifications made)*



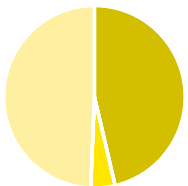
Commentary

- **Most reclassifications are among FV measurement categories,** split evenly between AFS instruments reclassified as FVPL (due to non-SPPI features) and AFS equity instruments reclassified as FVOCI without recycling.
- **Most AFS debt instruments will be retained as FVOCI**, although reclassifications have been made to AC for portions of *High Quality Liquidity Assets* (HQLA) portfolios because of insignificant sales (neither volume nor frequency).
- **Among European and American banks, expected impacts mainly relate to investment banking and treasury activities because of business model** (see next page).
- **Commercial and retail banks across all regions consistently expect limited reclassifications between accounting categories.**
- **No significant uncertainty on IFRS 9 interpretations for most banks**: Conclusions are not expected to change significantly for 68% of the respondents.
- **Fair value option for financial liabilities:** No significant changes are expected (see Appendix).
- **Overlay approach**: One-third of the respondents having insurance activities, 8 out of 24 banks, intend to apply the overlay approach (see Appendix).

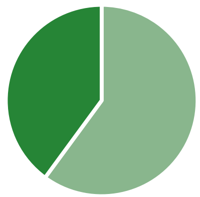
From AC to FV



Between FV categories



From FV to AC



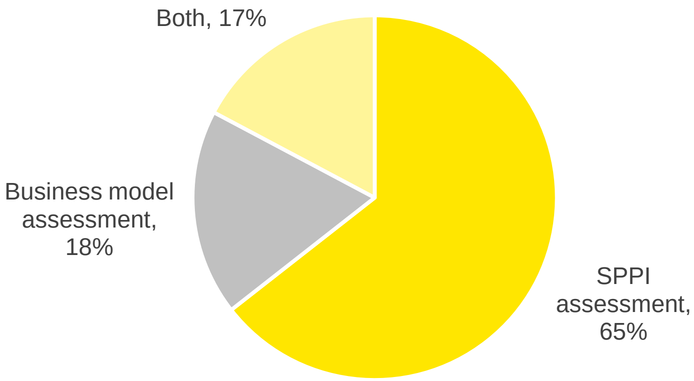
45% of reclassifications towards FVPL (as highlighted on page 3)

*Figures based on 29 responses.

2. Impact assessment
Expected reasons for reclassifications

Data

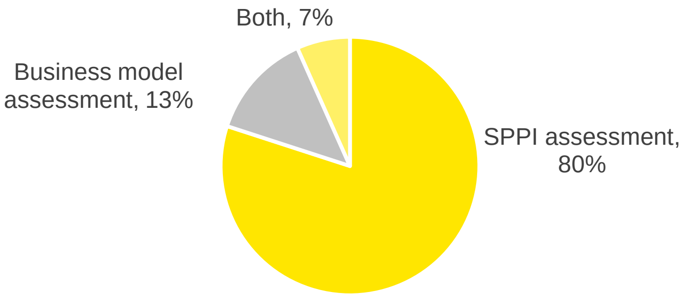
Expected reasons for reclassifications to FVPL reported by banks



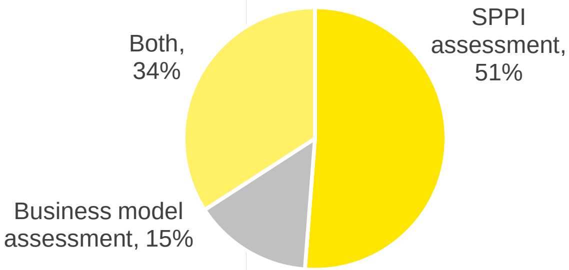
Commentary

- **Most reclassifications (65%) from L&R, HTM and AFS to FVPL only are solely due to contractual terms that are not SPPI** (see detail on pages 9-13).
- **Most reclassifications from AFS to FVPL are due to SPPI test failure.**
- **Out of the total reclassifications to FVPL, FVOCI and AC, 45% are due to the business model**, including reclassifications between FV measurement categories
  - US GAAP reporters note a reclassification of reverse repos portfolios into FVPL, as an interplay with the *Fundamental Review of the Trading Book*
  - Some portfolios of debt instruments are reclassified at FVPL either because are managed on an FV basis (e.g. reverse repos) or are originated to being distribute (e.g., syndicated loans).
  - As noted on the previous page, portions of HQLA portfolios which are previously classified as AFS, have been reclassified as AC on the basis of business model assessment (insignificant sales both in terms of volume and frequency).

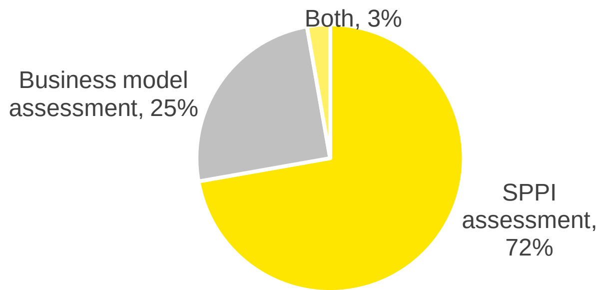
From HTM to FVPL: 15 banks*



From L&R to FVPL: 41 banks*



From AFS to FVPL: 36 banks*

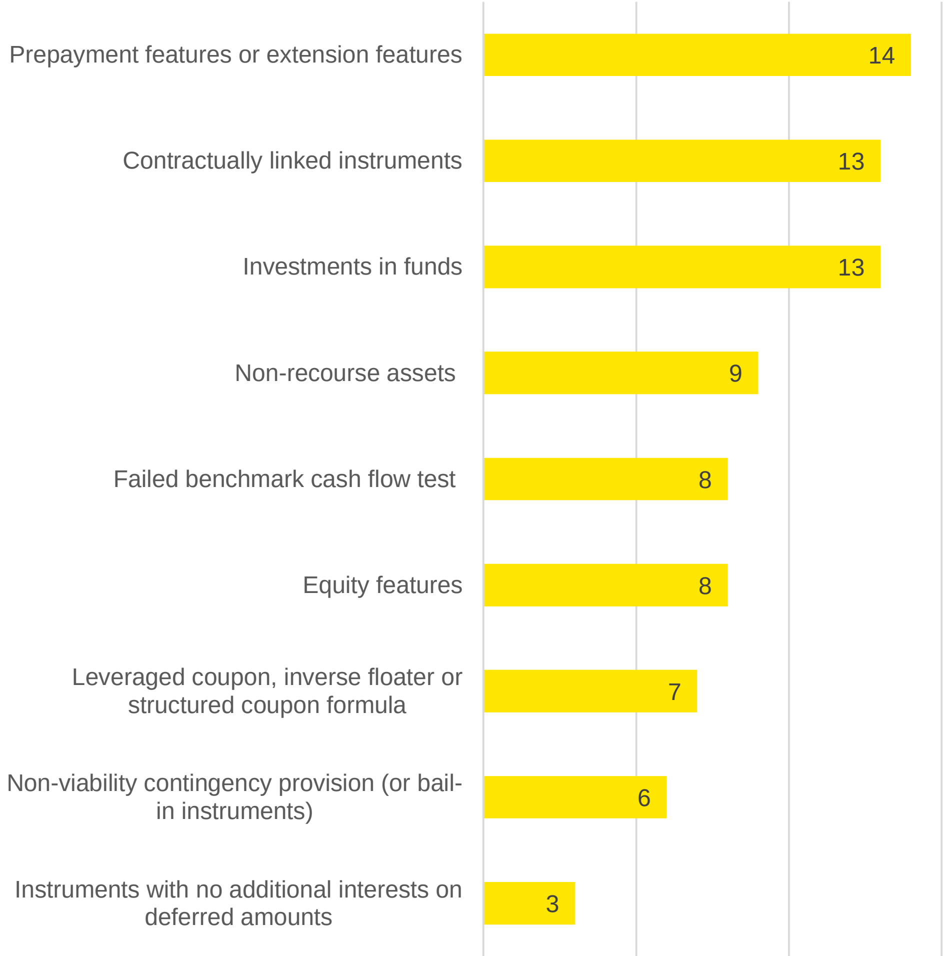


* The graphs represent the percentage of banks who responded to the questions.

3. SPPI test
Reasons for failure

Data

Non-SPPI contractual terms (number of banks)



Commentary

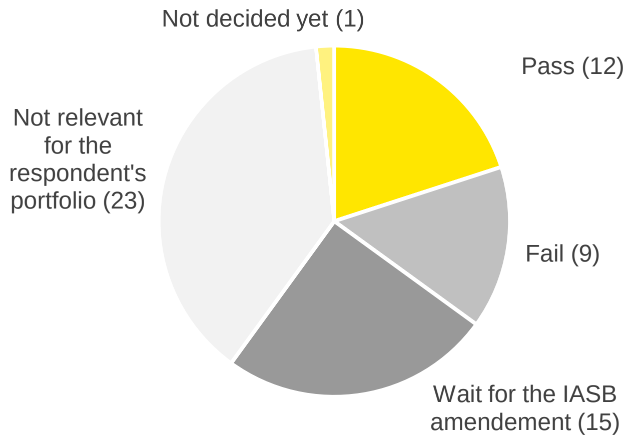
- **On average, banks identify two causes of SPPI failure**:
  - Between one cause (for 18 banks) and five causes (for one bank) have been identified.
  - 12 banks answered "not applicable" or no SPPI fails.
- **Prepayment and extension features are the most common triggers of an SPPI failure**
- Products for which the impact seems to be more significant also include:
  - Non-recourse assets (corporate and investment banking)
  - Mortgages with no additional interest on deferred amount
  - Products with no interest rates (consumer financing)
  - Investments in funds which do not meet the definition of equity.
- A couple of US overseas subsidiaries reported that some of their intercompany loans fail the SPPI test because the rate is linked to the cost of funding of the group to which they belong.
- Some respondents noted that they are discussing with peers and external auditors about the SPPI interpretation of "de minimis" and "not genuine" concepts, which represent significant areas of judgment.

3. SPPI test

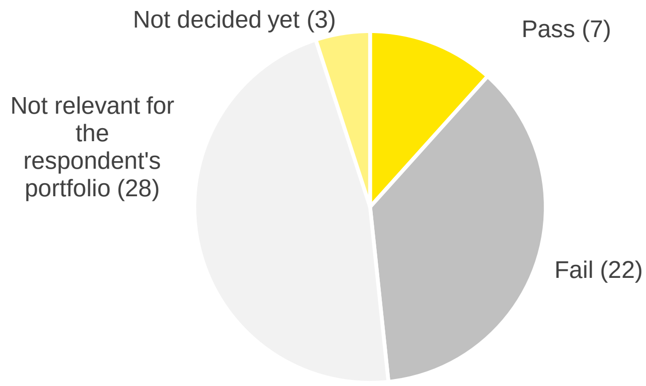
Reclassifications linked to SPPI test - focus on prepayment options

Data

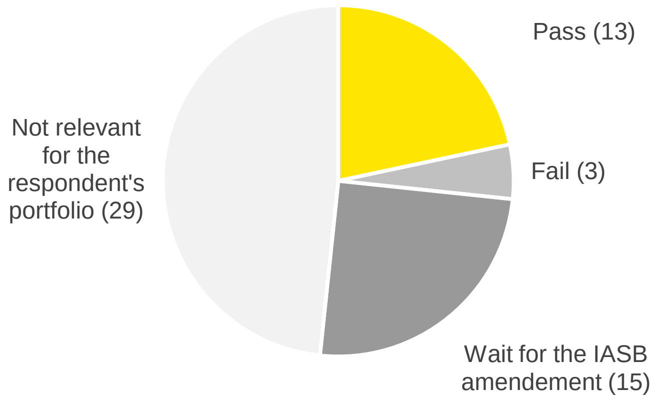
Prepayment at fair value



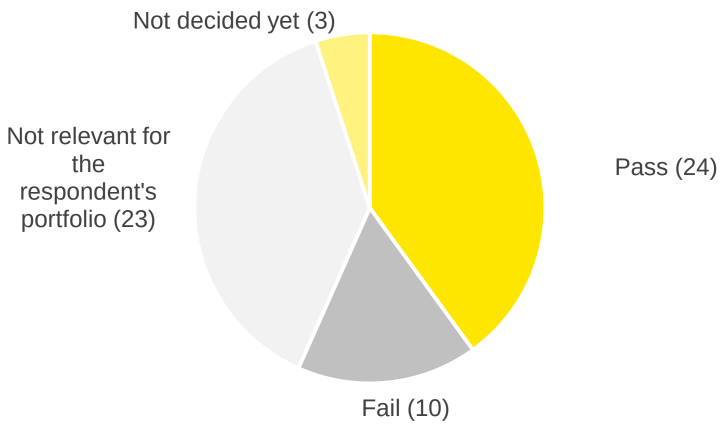
Prepayment higher than fair value



Two-way break clauses



Penalty set by local legal framework



Commentary

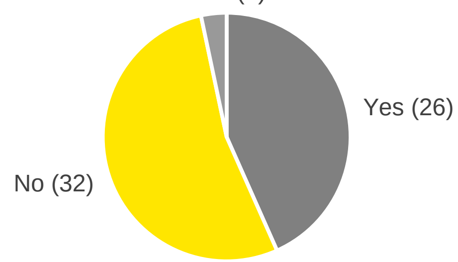
Prepayment feature is the most common cause of SPPI failure

- Two main types of prepayment clauses are seen as SPPI-breaches:
  - Prepayment at an amount that can be significantly higher than the fair value
  - Prepayment at fair value (pending the outcome of the IASB amendment).
- Since the survey has been finalised, the IASB has issued the amendment to the SPPI criterion in relation to prepayment options. The guidance on prepayment at FV, however, is viewed by many banks as still not clear.
- On the contrary, no significant issue is expected in relation to two-way break clauses for half of the banks.

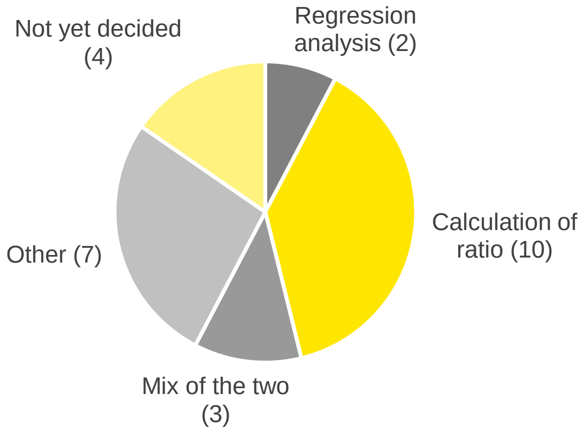
3. SPPI test
Modified time value of money element

Data

Development of a quantitative assessment for the modified time value of money element (i.e. benchmark cash flow test)



Methods of quantitative assessment*



Commentary

Different approaches when implementing the assessment

- To assess the modified time value of money element, ongoing quantitative and qualitative assessment have been included in the process by many banks

Quantitative methodologies generally based on ratio calculations

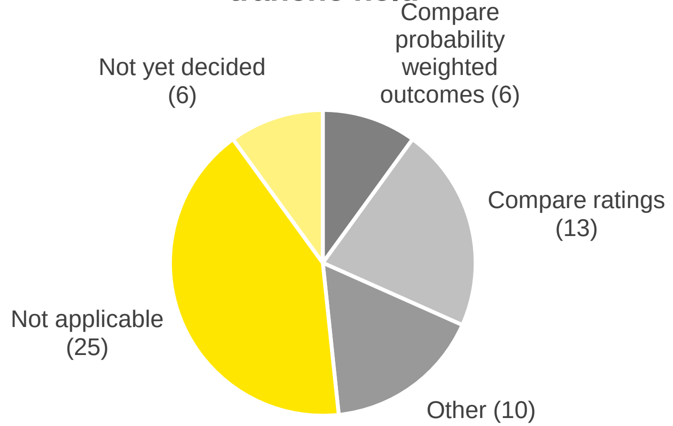
- Banks that are developing a quantitative benchmark cash flow test will use different approaches to compare undiscounted cash flows, such as the calculation of ratios, the development of a regression analysis or a mix of both.
- When calculating ratios, half of the banks intend to include the principal amount. Depending on the maturity of products, this may require adjusting the threshold to capture the effect of modified interest cash flows.
- When using regression analysis, banks also need to test the potential impact by period as well as cumulatively over the life of the products.**
- The scenario generation will be based on historical spot and forward interest rates, considering a more than 10 years observation period.
- Approaches to take into account the "reasonably possible scenarios" most common are:
  - To exclude scenarios from the upper and lower tails of the distribution on the basis of a determined confidence interval
  - To use a limited number of specific scenarios
- The banks that have implemented a quantitative assessment (excluding those still undecided) have included a quantitative threshold in the model, with a diversification based on maturity and financial asset characteristics. For the other banks, a case-by-case analysis is required.

* The graph contains responses provided only by the respondents of the "Yes" answer in the graph above.
** The regression analysis may not comply with IFRS 9 methodology, therefore the method should be previously discussed with auditors before it is adopted.

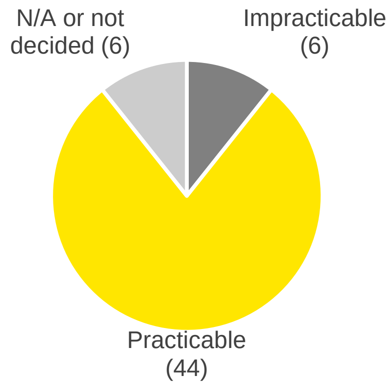
3. SPPI test
Contractually linked instruments (CLIs)

Data

Assessing the exposure to credit risk of the tranche held



Practicability of the "look-through" analysis



Commentary

Large spectrum of approaches for the credit risk assessment

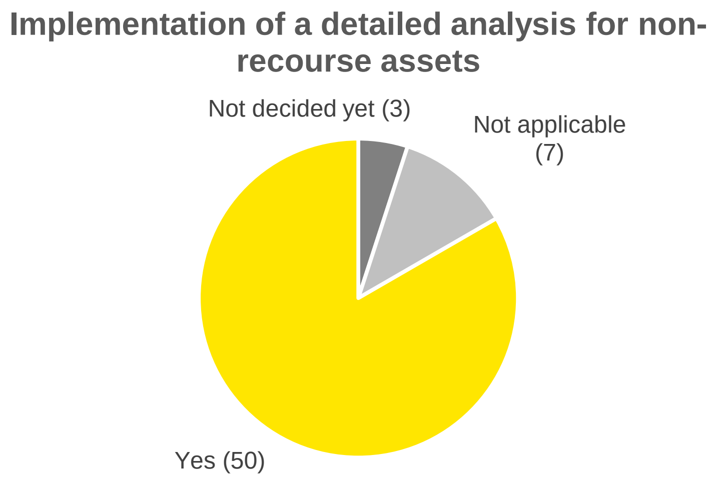
- Six banks, who do hold CLIs, have not decided yet on the specific methodology for the credit risk test.
- Some banks have developed a quantitative tranche test comparing the probability of default of the tranche held with the probability-weighted probability of default of the pool. The test fails when the tranche probability of default is more than the pool probability of default.
- For those who have developed a credit risk test approach, the comparison of the tranche and the pool ratings is the most common approach.
- A number of respondents highlighted simplified approaches:
  - European banks and one from North America are considering the most senior tranche SPPI compliant, while junior tranches will be measured at fair value through profit or loss.
  - 2 respondents will assess the credit risk through the yield (or spread) differential between the tranche and the pool.

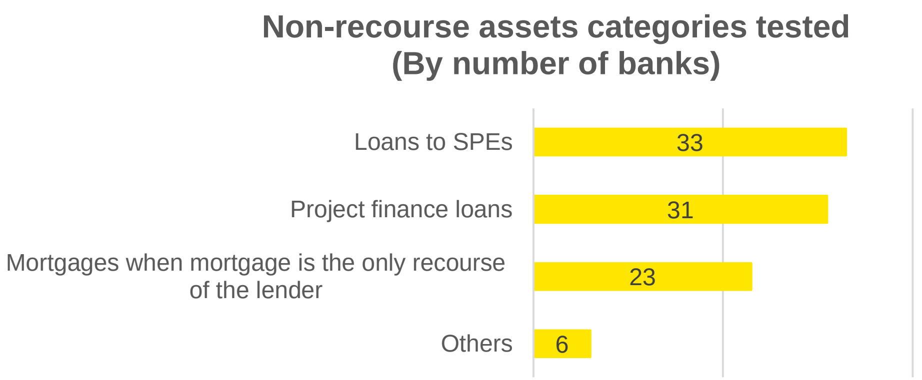
Only few banks consider that the “look-through” analysis is not practicable

- This view normally leads to FVPL classification.
- Nevertheless, among these banks, some seem to have used shortcuts, suggesting they did not mechanically conclude that they should classify the instrument at FVPL.

3. SPPI test
Non-recourse assets

Data





Commentary

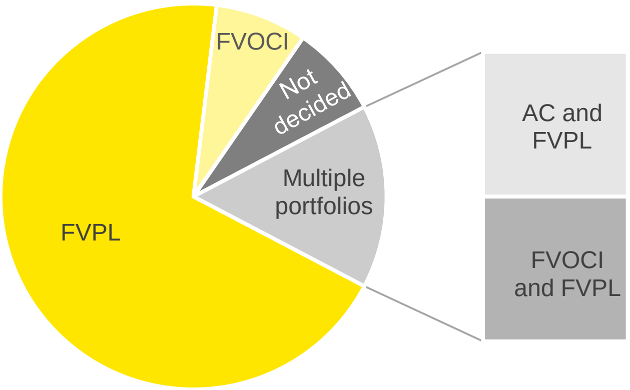
Fifty banks already developed a specific analysis for the purpose of identifying non-recourse assets

- Only 10 banks did not test any asset for the non-recourse feature, mainly because it was considered as not applicable (i.e., 7 banks).
- For those that did identify the non-recourse assets, they have listed the following:
  - Project finance
  - Loans to special purpose entities (SPEs)
  - Equity release mortgages with a no-negative equity clause
  - Non-recourse operating leases
- Other non-recourse assets identified by six banks include:
  - Shipping loans
  - Leverage finance
  - Aviation finance
  - Secured finance transactions (i.e., loans secured by other financial instruments' portfolios)
  - Some factoring transactions

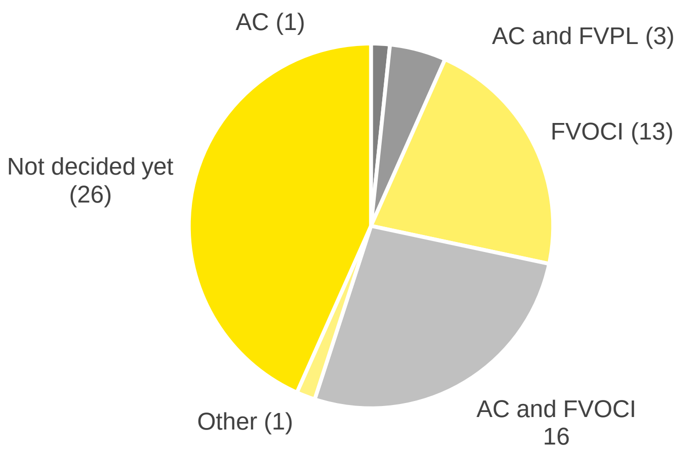
4. Business model test
Reclassifications linked to business model

Data

Originate-to-distribute portfolios



Business model of the liquidity portfolio



Commentary

The majority of banks (more than 75%) do not hold loans and receivables with a potential "originate to sell/distribute" business model

- Among those who answered positively (mainly for syndicated loans), there is an FVPL consideration for the syndicated portion.
- Among banks with an underwriting activity, where they partially de-risk their exposure over a short period (generally 90 days), such as leveraged finance or commercial real estate activities, there is a consensus to classify the "left to sell" portion of the loan in the residual business model (FVPL) and the "approved hold" component of the loans as "held to collect"

The destination of the high-quality liquidity portfolio is still under discussion

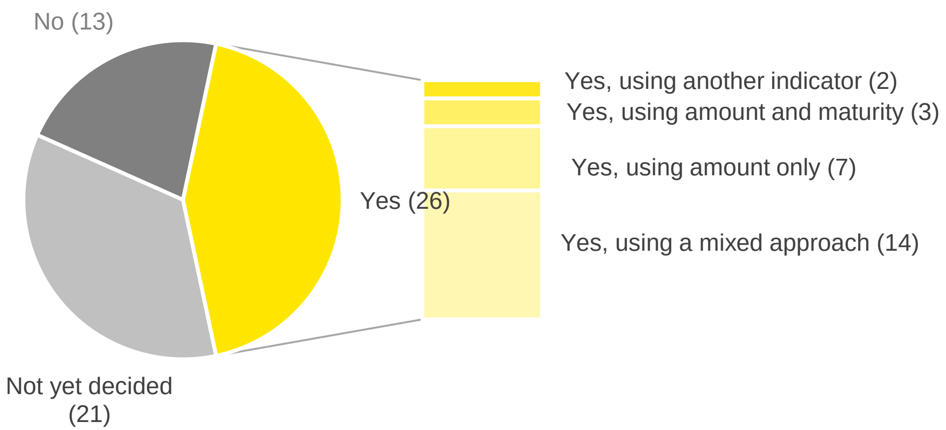
- Among banks that are considering a split of the portfolio:
  - 16 participants (including 10 European large banks and 4 Asian) intend to use a "held to collect and sell" and "held to collect" combination
  - The other 3 are considering a trading mandate for the portfolio held to manage short term liquidity needs where a "held to collect" model for the portfolio held to maturity other than in a liquidity crisis
- A significant number of banks, on the other hand, state that the portfolio is "held to collect and sell".
- The business model "other" is not the preferred allocation.

4. Business model test

Sales of financial assets classified as held to collect

Data

Setup of a threshold for held to collect portfolio



Commentary

Most banks are determining a quantitative threshold to assess the consistency of a held to collect business model

- The most common approach relies on the amount of the assets sold as compared with the total amount of the portfolio.
- A smaller number of banks will also take into consideration the average maturity of the portfolio defining a descending threshold.
- A few banks (3) will mix two indicators: volume of sales and effect on the income statement.

Of the banks that remain undecided, the vast majority (14 out of 21) are European banks, which are either discussing with their consultants and external auditors or waiting for a market consensus

Threshold for sale of held to collect assets

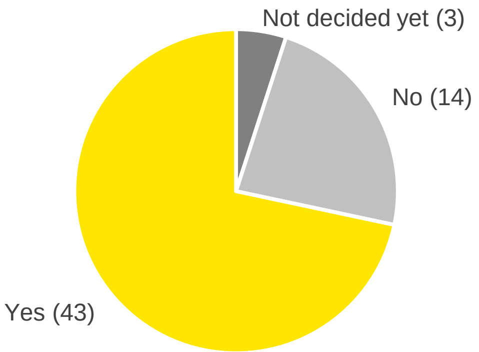
- The most common approach to set the "significance" threshold for held to collect assets is to rely on the amount of the asset(s) sold as compared to the total amount of the portfolio.
- Respondents who are not setting a quantitative threshold are considering a qualitative analysis to be conducted in a case-by-case approach.
- Some example thresholds for illustrative purposes are (also reported in the graph on the left):*
  - A limit based on 15% on a one-year duration for a portfolio
  - A sale is considered significant if it constitutes 5% or more of the total portfolio value at the time the decision to sell is taken.

* These thresholds do not represent EY's view.

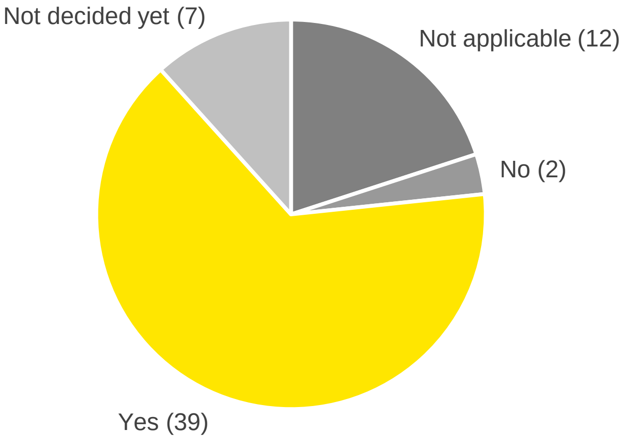
5. Equity instruments
Other comprehensive income (OCI) election

Data

Use of the OCI election



Election on a line-by-line analysis

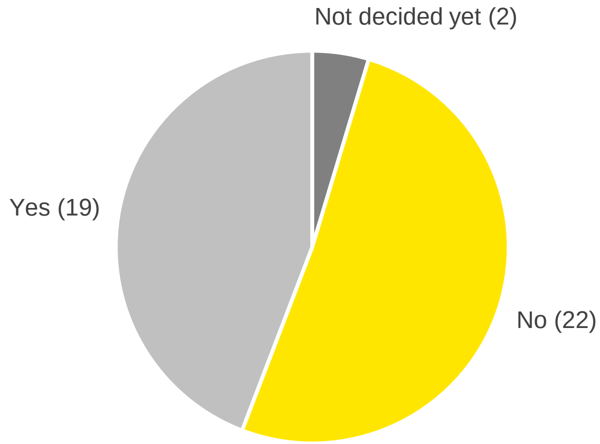


Commentary

Clear trend which shows the use of the irrevocable election at FVOCI (non-recycling)

- Over half of the banks will use the election for strategic or long term investments.
- Most banks will determine the use of the election on a line-by-line basis.

Use of the option only for strategic investments*

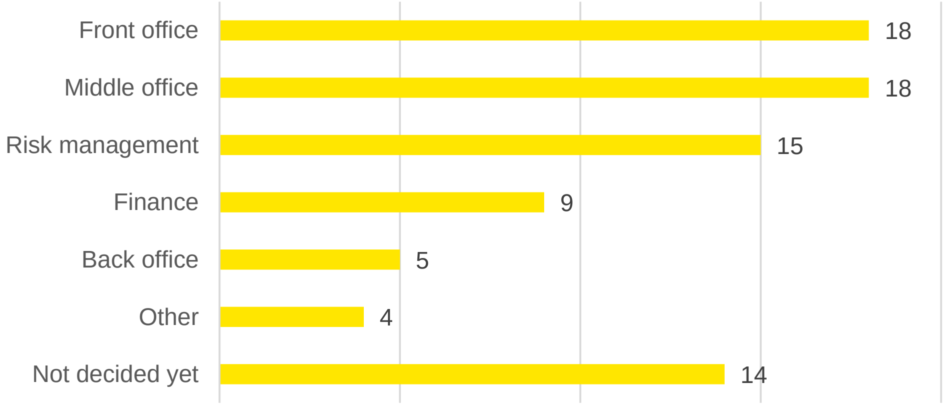


* The count of unanswered have been removed from the cumulative count.

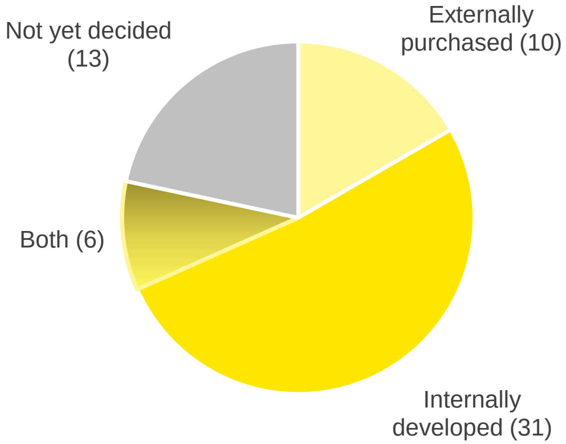
6. Operating model
C&M ongoing assessment

Data

Areas involved in the C&M ongoing assessment *



Development of the SPPI tool



* The total is more than 60 as some banks selected more than one option.

Commentary

Responsibility split between finance, risk and business functions

- Most banks (62%) have indicated that the ongoing assessment of the new classification requires the input of multiple stakeholders.
- The remaining 38% intend to apply a centralised governance for both SPPI and the business model assessment.

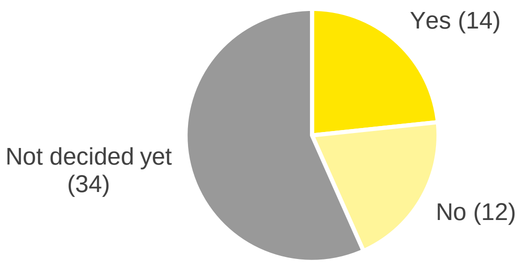
Half of respondents intend to develop the SPPI tool internally

- Most participants are setting up an internal engine for the SPPI assessment on the basis of guidelines and checklists developed internally.
- 10 respondents decided to externally purchase an SPPI tool, requiring a different degree of customization:
    - 6 out of 10 are small banks in the early implementation phase, suggesting they opted for the acquisition of the tool externally in order to speed up the development process.
- A few banks have both developed an internal tool (for loans and unquoted instruments) and purchased an external tool for quoted securities (with data available on market data providers).
- Other banks do not plan to build an SPPI tool, and will, instead, integrate a qualitative SPPI testing in their new product approval process, with some large, global banks putting in place a hub of C&M champions within the bank.

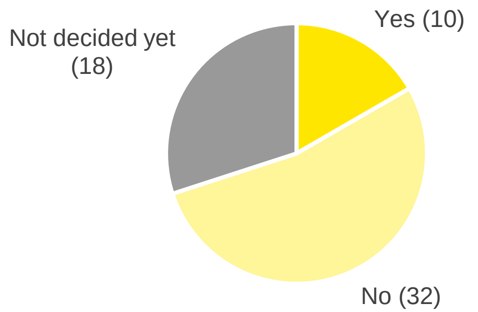
6. Operating model
Impact on governance and products offered or acquired

Data

Impact on products' approval framework



Impact on product types



Commentary

Most banks have not decided how to validate and authorise the origination of new products on the basis of the new IFRS 9 C&M requirements

- Only 14 banks have already decided to modify the processes to validate and authorize the origination of new products on the basis of the new IFRS 9 C&M requirements.

Inclusion of IFRS 9 tests outcome in the deal's approval documentation

- For those planning to modify current processes, considering the SPPI test as part of the process, the most common actions taken are to:
  - Include the test outcome in the instrument's approval documentation
  - Develop specific guidelines in order to prevent banking book products failing the SPPI test

Only a few respondents show operational impacts on the portfolios of products offered

- Only few European banks intend to amend certain portfolios or instruments as a result of the SPPI test performed. The most common identified features or clauses which they would like to amend relate to non-recourse, hurdle rates, indefinite maturity dates, zero interest rate and variable rates with mismatches.

Appendix

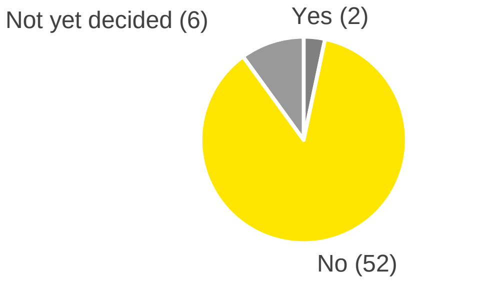
The appendix includes the topics below that may not necessarily be directly related to C&M but are still considered to be key considerations of IFRS 9.

- **Scope of fair value option (FVO) for financial liabilities**
- **Application of the overlay approach for insurers**
- **IFRS 9 hedge accounting approach**

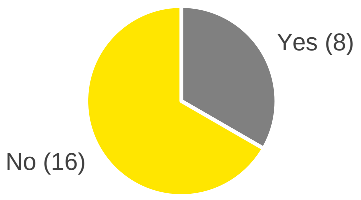
7. Appendix
Fair value option for financial liabilities and overlay approach

Data

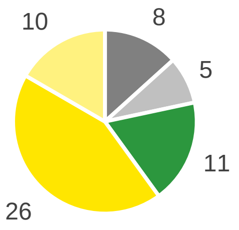
Changes in the scope of fair value option for financial liabilities



Application of the overlay approach



Hedge accounting approach in 2018



Commentary

Scope of FVO for financial liabilities

- Respondents do not expect any significant change in the scope of the fair value option for financial liabilities.
- The only exceptions concern repo liabilities and prime brokerage liabilities.

Application of the overlay approach for insurers

- Among the 24 respondents with insurance activities, 8 have decided to apply the overlay approach for IFRS 9 for the consolidated financial statements.

Most banks will not apply IFRS 9 hedge accounting in 2018. They will:

- Apply IFRS 9 hedge accounting with no use of IAS 39 macro-fair value hedge model.
- Apply IFRS 9 hedge accounting with use of IAS 39 macro-fair value hedge model.
- Remain on IAS39 hedge accounting for 2018, but may adopt IFRS 9 hedge accounting earlier than when required.
- Remain on IAS39 hedge accounting for as long as permitted.
- Take a decision later.

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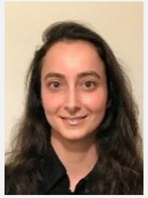

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