EUROPEAN CENTRAL BANK

BANKING SUPERVISION

SSM thematic review on IFRS 9

Assessment of institutions' preparedness for the implementation of IFRS 9

November 2017

Contents

Executive Summary

An important lesson learnt from the financial crisis is that incurred loss models used in bank accounting standards often resulted in provisions that were considered “too little, too late”. This led the G20 leaders to recommend that accounting standard-setters consider modifying provisioning standards to incorporate forward-looking information in the estimation of credit losses. To address this, the new accounting standard for financial instruments (IFRS 9) was designed to ensure more adequate and timely recognition of provisions. IFRS 9 also introduces new classification and measurement requirements, according to which financial assets are classified on the basis of the business model within which they are held and their contractual cash flow characteristics.

The standard becomes effective on 1 January 2018 and will replace the current accounting standard, IAS 39. Given the complexity of the new standard and the challenges that institutions are expected to encounter when implementing it, within the framework of the Single Supervisory Mechanism (SSM) it was decided to conduct a thematic review on IFRS 9 for significant institutions (SIs) and for less significant institutions (LSIs) as part of its supervisory priorities for 2016 and 2017. The review for SIs covers all significant institutions reporting under IFRS[1] and was performed by the Joint Supervisory Teams (JSTs). It is based on information made available by the institutions during the first quarter of 2017, and involved analysing the relevant documents, interviewing the banks’ management and conducting supervisory dialogues to circulate and discuss the results. The assessment was mainly based on what are considered best practices at international level, which are set out in the guidance issued by the Basel Committee on Banking Supervision (BCBS) and the European Banking Authority (EBA). The thematic review for LSIs was performed on a sample of institutions, in close collaboration with the national competent authorities (NCAs). It is based on a self-assessment survey, building on the EBA templates and taking into account the proportionality principle and the specificities of LSIs. The primary objectives of the thematic review for SIs and LSIs are to assess to what extent institutions are prepared for the introduction of IFRS 9, to assess its potential impact on provisioning and to promote consistent application of the new standard.

This report presents the first quantitative and qualitative results of the thematic review on IFRS 9 for SIs and LSIs.

Based on information reported by SIs which are at an advanced stage of implementation (and thus those with the most reliable data), the fully loaded average negative impact on the regulatory Common Equity Tier 1 (CET1) ratio is estimated to be 40 basis points (bps). From the data reported by LSIs at an advanced stage of preparation, the fully loaded average negative impact on the regulatory CET1 ratio is 59 bps. This result suggests that the impact in prudential terms of IFRS 9 on

1 With some exceptions as detailed below: see the paragraph about the scope of the review.

institutions applying the standardised approach (SA) is likely to be greater than for institutions applying the internal ratings-based (IRB) approach to credit risk.[2]

Besides the quantitative impact, the report provides a summary of the main qualitative results of the thematic review for SIs and LSIs, reflecting several areas identified as highly relevant for the process of implementing IFRS 9. The overall conclusion is that for some institutions there is still room for improvement if a high quality implementation of IFRS 9 is to be achieved. Overall, the supervisors have noted that the largest SIs are more advanced in their preparation than the smaller SIs. The aspect considered to be the most challenging is impairment measurement, which requires significant changes to the institutions' internal processes and systems. However, institutions also encountered challenges with the classification and measurement of financial instruments. The thematic review on SIs and LSIs has shown that the vast majority of institutions are working intensively on the implementation of IFRS 9. Many of them have already completed the mapping of financial instruments for classification and measurement purposes and are leveraging on their existing internal models as a basis for implementing the new ECL impairment framework. Despite their efforts, many institutions still have to reinforce their governance of ECL models and improve their accounting policies, which are often too vague. Improvements are needed, for instance, regarding the solely payments of principal and interest (SPPI) test and the definition of default for accounting purposes. Similarly, further developments are still needed in the significant increase in credit risk (SICR) assessment, incorporation of forward-looking information in ECL measurement, validation and back-testing. In many cases there is still room for aligning the accounting definitions with the regulatory definitions. Furthermore, institutions are still in the process of incorporating the EBA guidelines on ECL into their policies and procedures.

The scope of this supervisory exercise encompasses 106[3] SIs which prepare their financial statements in accordance with IFRS at the highest level of consolidation and are directly supervised by the ECB. To support this supervisory exercise, ECB Banking Supervision and the NCAs developed guidance containing supervisory expectations and scoring criteria for the assessment of SIs with the aim of performing a consistent assessment of institutions' preparedness for implementing IFRS 9 and supporting the implementation of IFRS 9. Following this, simplified methodological guidance for LSIs, taking into account the specificities of those

[2] Based on the quantitative information submitted by the institutions, the average impact on CET1 is expected to be higher for LSIs. One possible explanation is that LSIs predominantly apply the standardised approach (SA) to credit risk prudential requirements. As a very simplified example, if two institutions have the same level of risk in their exposures, the same level of increase in accounting provisions would have a bigger impact on CET1 for portfolios under the SA approach than on portfolios under the IRB approach owing to the prudential treatment of the accounting provisions (assuming that the institution applying an IRB approach has a shortfall and, as such, is already deducting this shortfall from CET1). The difference between accounting provisions under IAS 39 and prudential expected losses for portfolios under the IRB approach – the shortfall – will absorb (totally or partially) the impact on CET1 of the increase in accounting provisions when IFRS 9 is first applied (which would not be the case for portfolios under the SA approach).

[3] The thematic review on IFRS 9 is carried out at the highest level of consolidation. Some significant institutions have been exempted from the scope of this exercise because: (i) they apply National GAAP instead of IFRS; (ii) they are subsidiaries of significant institutions or branches; (iii) individual exemptions were made based on idiosyncratic factors (e.g. mergers).

institutions, was produced for the NCAs to use. The thematic review for LSIs was performed on a sample of 77 institutions in close collaboration between ECB Banking Supervision and the NCAs.

The first phase of the exercise for the SIs was conducted for the institutions that were prepared for the assessment in the first quarter of 2017. Those institutions that were not fully prepared for the assessment received a warning letter during the first quarter of 2017, and will be assessed by the JSTs by 30 November 2017. Findings and remedial actions will be communicated to the institutions and the JSTs will follow up on outstanding issues throughout 2018. Nevertheless, supervisory dialogues have already been held with those institutions (partially or fully) assessed under the thematic review, and these have largely confirmed the findings identified. However, in all the areas covered by the thematic review for SIs, the supervisors have observed that institutions have made some progress following the discussions on the individual findings. The most notable improvements have been identified for a limited number of institutions in the area of governance, followed by business model, SPPI test and the definition of default. Several institutions have also reported improvements in SICR methodology and their measurement of ECL. Nonetheless, many issues regarding the implementation of IFRS 9 still need to be overcome. The supervisors will closely monitor the progress of institutions' implementation of the new standard.

1 Overall results of the thematic review on IFRS 9

As expected, the implementation of the new standard is a major challenge and institutions are making a considerable effort to be adequately prepared for the first application date. On the basis of the first results of the thematic review, it is clear that at some institutions there is still room for improvement. This is not only the case for the impairment framework, which requires significant changes to internal systems and processes, but also other aspects related to the classification and measurement of financial instruments, which are not yet at the required minimum level for many institutions. The new ECL framework is generally considered the most challenging part of the IFRS 9 standard as it requires a significant increase in the role of risk management, data availability and expert judgement for accounting purposes, for which strong governance and clear internal processes have to be in place.

Overall, the supervisors have noted that the level of preparedness varies across the institutions assessed. Therefore, SIs that were considered to be lagging behind their peers in the implementation of IFRS 9 received, in the first quarter of 2017, a letter from the supervisors highlighting the main concerns about their progress and requesting that an action plan be drawn up. From several discussions with the industry, it is clear that this initiative, as well as the launch of the thematic review itself, has contributed to an increase in the institutions' awareness of the challenges associated with implementing the standard. As a result, many of them have taken corrective measures and dedicated more resources to the project.

1.1 Quantitative results of the thematic review on IFRS 9

The supervisors have also collected institutions' estimates of the potential quantitative impact and corresponding impact on regulatory capital ratios of IFRS 9 when it is first applied, based on data that were available as of the first quarter of 2017. The average estimated quantitative impact for the significant supervised institutions covered by the thematic review is broadly in line with the results achieved for the sample of institutions included by the EBA in its second impact assessment of IFRS 9[4] published on 13 July 2017. Considering only the better prepared institutions from the SI sample, the average fully loaded negative impact of IFRS 9 on the CET1 ratio is 40 bps[5]. This impact is lower than the average impact for the entire sample of significant institutions covered by the thematic review.

4 See EBA report on results from the second EBA impact assessment of IFRS 9

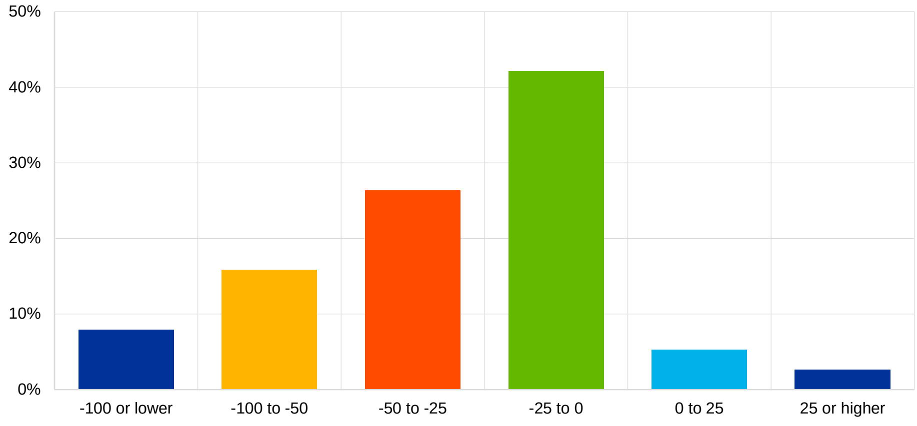
5 The average only includes institutions reporting a negative impact.

Chart 1

IFRS 9 quantitative assessment: impact on CET1 ratio for SIs[6]

Impact in ranges displayed for institutions at a more advanced level of preparedness

(Units: basis points. Vertical axis: percentage of institutions. Horizontal axis: impact on CET1 ratio)



Source: Data derived from the quantitative templates provided by institutions

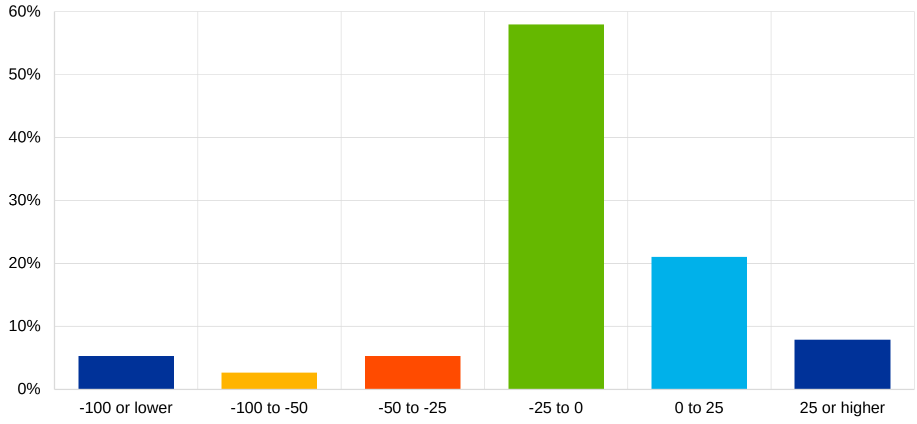
With a view to the upcoming supervisory stress test in 2018, which for the first time will take IFRS 9 into account, ECB Banking Supervision encourages institutions to allocate appropriate resources to this exercise, also in order to ensure that data requests can be processed in an efficient and accurate manner and in compliance with the relevant stress-test methodology.

Chart 2

IFRS 9 quantitative assessment: impact on CET1 ratio for LSIs

Impact in ranges displayed for LSIs at a more advanced level of preparedness

(Units: basis points. Vertical axis: percentage of institutions. Horizontal axis: impact on CET1 ratio)



Source: Data derived from the quantitative templates reported by LSIs

6 The ranges presented refer to the total impact of the application of IFRS 9, meaning the impact arising from classification and measurement and the impact arising from the recognition of ECL. The positive impact presented in the chart is mainly related to the impact arising from the classification and measurement of financial instruments in accordance with the new accounting rules under IFRS 9.

In the case of LSIs, and considering only those LSIs from the sample that are at an advanced level of preparedness, the fully loaded average negative impact of IFRS 9 on CET1 ratio is 59 bps[7]. Similar to SIs, the impact is lower than the average impact for the entire sample, while the most significant impact results from the new impairment requirements.

1.2 Qualitative results of the thematic review on IFRS 9

The thematic review for SIs has focused on nine areas identified by the supervisors as highly relevant in terms of the proper implementation of IFRS 9. This report provides an overview of the conclusions, taking into account each of the focus areas and highlighting some of the best practices observed. For SIs, these results are based on the assessment performed in the first quarter of 2017, also incorporating the outcome of the supervisory dialogue conducted with each institution by mid-July 2017. For LSIs, the results are based on the assessment performed on 77 institutions.

As such, it is important to note that all the aspects mentioned in the report could have improved in the meantime. The supervisors are continuously monitoring the implementation activities conducted by the institutions, in particular those related to the recommendations provided for specific issues identified during the assessment.

Most of the findings apply to both SIs and LSIs. In those cases where material differences between the findings for SIs and LSIs were observed, an explicit reference is included in the report.

1.2.1 Governance, processes, systems and disclosures

Overall, institutions are working intensively on adapting their processes to IFRS 9 and investing substantially in the development of their IT systems. Most project plans were deemed largely adequate, as they involved all levels of management and all relevant organisational units (in particular Risk, Finance, Business, IT and Audit). Where the outcome of the assessment was not satisfactory, the supervisors encouraged institutions to improve their project governance, stressing that the management body's involvement and accountability are crucial. Further areas of improvement are the availability and quality of internal documentation regarding the ECL methodology and disclosure policies. For the latter, improvements were observed for some institutions following the supervisory dialogue.

Finally, rigorous governance and internal control processes for assessing external vendors are expected to be in place. This is even more relevant for smaller institutions, given their increased reliance on third-party products such as models, data and scenarios. Products provided by external vendors should be tailored to

7 The average only includes institutions reporting a negative impact.

reflect the institution's risk profile and should be well understood by the institution itself.

1.2.2 Assessment of business models for the classification of financial instruments

The vast majority of SIs have developed draft policies and put adequate procedures in place for the business model assessment in order to classify financial instruments according to the new criteria. Furthermore, most of the institutions had already carried out an initial mapping of the existing financial instruments/portfolios to the identified business models.

However, in some cases draft policies setting out the rules for the classification of financial instruments within business models appear to be rather vague, leaving excessive room for interpretation. While some institutions have addressed these weaknesses in the meantime, most institutions still have to work on this. In particular, it was noted that in several cases the policies for the business model assessment lacked a clear link to the institution’s governance, remuneration arrangements and risk management. Another area where accounting policies should be more precise is the reclassification of financial instruments as a result of changes to business models.

Finally, clearer definitions of the level of sales of financial instruments to be considered infrequent or insignificant are still needed.

1.2.3 Classification and measurement: solely payments of principal and interest (SPPI) test

Most of the SIs have standardised processes in place to test whether the contractual cash flows of a financial instrument constitute solely payments of principal and interest. The SPPI test must be passed in order to classify financial instruments at amortised cost or at fair value through other comprehensive income (FVOCI). These standardised processes often consist of detailed checklists and decision trees that have been developed internally or by external consultants.

Some institutions, both SIs and LSIs, lack a clear definition of the benchmark test needed to assess whether financial instruments with a modified time value of money meet the SPPI criterion. The supervisors are monitoring progress in this area closely. As a general expectation, the institution should have a standardised process in place in order to assess and identify in their systems financial instruments with critical SPPI features.

1.2.4 Impairment: definition of default for IFRS 9 purposes

SIs are generally applying a consistent definition of default for both internal credit risk management purposes and IFRS 9. Moreover, institutions are aligning the accounting and regulatory definitions of default, although progress in this area is still needed for some institutions. In this sense, the supervisors encourage the use of the EBA non-performing exposure definition for internal risk management and public financial reporting purposes[8]. One of the areas where institutions can improve is in the setting of consistent materiality thresholds for the identification of default, although, in general, there is a commitment to aligning these with the ones which will be applicable for regulatory purposes[9]. Similarly, institutions should define more precisely the conditions for transferring the exposures out of stage 3 classification (i.e. credit-impaired exposures), including the potential definition of cure periods in line with the relevant EU prudential regulation[10].

1.2.5 Impairment: significant increase in credit risk (SICR) assessment

At each reporting date institutions have to assess whether a significant increase in credit risk (SICR) has occurred since the initial recognition of a financial instrument. This has to be done in order to determine whether expected credit losses are measured as lifetime expected credit losses, meaning whether those exposures should be transferred from stage 1 to stage 2 of impairment. This SICR assessment should be based on both quantitative and qualitative indicators.

A majority of both SIs and LSIs focus their assessments on quantitative indicators. The relative change in the probability of default (PD) is the main identifier (accompanied by an absolute change in PD) of whether or not a SICR has occurred. The supervisory expectation is that the inclusion of exposures in the watch list, the application of forbearance measures or the 30 days past due trigger being reached are used by institutions as backstop indicators. The results of the thematic review for SIs and LSIs confirm that some institutions are meeting this expectation. A definition of clear rules and potential cure periods for transferring exposures classified as stage 2 back to stage 1 is an area that deserves more attention from the institutions.

In addition, some SIs and LSIs plan to use the “low credit risk” exemption. This permits institutions to assume that the credit risk on a financial instrument has not increased significantly since initial recognition if the financial instrument is determined to have “low credit risk” at the reporting date. However, it is recommended that these exemptions are well documented, justified and, regarding lending exposures, limited.

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8 See Guidance to banks on non-performing loans.

9 EBA Draft Regulatory Technical Standards 2016/06 on the materiality threshold for credit obligations past due under Article 178 of Regulation (EU) No 575/2013

10 Commission Implementing Regulation (EU) 2015/227 of 9 January 2015 amending Implementing Regulation (EU) No 680/2014 laying down implementing technical standards with regard to supervisory reporting of institutions according to Regulation (EU) No 575/2013 of the European Parliament and of the Council.

1.2.6 Impairment: incorporation of forward-looking information in the ECL impairment model

The majority of institutions will incorporate forward-looking information (FLI) in the ECL impairment model based on multiple scenarios. Most institutions will use a three-year period as a time horizon for FLI while another relevant number of institutions will use a three to five-year period. It is important that FLI is limited to a reasonable period to promote the reliability of forecasts. Regarding the potential need for improvements in this area, the governance aspect related to FLI is of the utmost relevance, as a significant number of institutions have insufficient internal documentation in relation to the incorporation of FLI. Additionally, a number of institutions plan to use only a few macroeconomic variables, such as gross domestic product (GDP), but have not identified other FLI which could be considered relevant in the determination of ECL at a more granular level.

The determination of collateral valuation can play an important role in the calculation of impairment loss provisions under the ECL model, particularly where collateral realisation is expected to happen sometime in the future. Because of this, institutions should apply a sufficient level of caution that reflects the inherent uncertainty. For instance, given the inherent execution risk in realising the value of collateral, institutions should very carefully consider cases where the secured element increases over time. Such cases should be backed by solid evidence that increased valuations are sustainable, as also outlined for immovable property in the guidance to institutions on non-performing loans[11].

In particular for LSIs, which tend to use FLI and macroeconomic scenarios developed by external vendors, it is important to stress that institutions should ensure that the scenarios are tailored to their business and credit risk exposure profiles. At this stage, only a few LSIs use internal macroeconomic analysis for scenario development. In addition, if expert judgement is applied, it should be explained and well documented. It is also important that any deviations resulting from the consideration of expert judgment by SIs and LSIs are directionally consistent with quantitative forecasts.

1.2.7 Impairment: validation and back-testing

Almost all institutions have room for improvement in developing a proper and reliable validation and back-testing process for IFRS 9 ECL modelling purposes. Some deficiencies were identified in the validation function, such as a lack of independence from model development, unclear definition of roles and responsibilities and a lack of resources and expertise. In addition, deficiencies in the validation framework have been found, such as the absence of a clear separation between model components (design/input/output). However, following the supervisory dialogue, some improvements were observed for SIs with regard to the process and its documentation.

[11] ECB Banking Supervision’s guidance to banks on non-performing loans, March 2017.

The LSI survey showed that these institutions are still in the process of developing a validation and back-testing framework. LSIs plan to validate and back-test the models once a year.

All institutions that demonstrated weaknesses in the area of validation and back-testing are strongly encouraged to assign sufficiently skilled staff to this area, as validation and back-testing processes should be in place ahead of 2018. Moreover, institutions should have comprehensive documentation on the model validation framework and process. The periodical reviews should ensure that model assumptions are still valid and newly available information is considered.

1.2.8 Impairment: calculation of lifetime ECL

All institutions are expected to follow the EBA guidelines on ECL[12], although the majority of these institutions have not yet transposed the guidelines into an internal policies manual.

All institutions using IRB models for regulatory purposes are developing IFRS 9 models based on probability of default (PD), loss given default (LGD) and exposure at default (EAD) parameters, mainly leveraging on existing prudential models. Institutions should, however, make sure that the differences between the IRB models and IFRS 9 model requirements are properly addressed through the necessary adjustments. Many institutions will derive the lifetime PDs from one-year PDs by using generally accepted approaches (e.g. migration matrices). Regarding LGD and EAD, institutions are at a less advanced stage in the development of their models, especially in relation to the incorporation of FLI. It is important to note that ECLs equal to zero should be rare, also for exposures with a low credit risk.

1.2.9 Impairment: additional considerations for portfolios under the standardised approach (SA)

As expected, institutions with supervisory-approved IRB models are generally well equipped in terms of expertise and modelling skills, also for portfolios currently under the SA. For institutions applying only the SA, however, the main challenge in the implementation of IFRS 9 lies in the development of the ECL framework. The latter holds in particular for LSIs, as they usually apply the SA to credit risk. Institutions identified a lack of (historical) data, resources and technical knowledge on modelling as the key challenges in developing the ECL framework. In a few cases, expert judgement is applied to validate or override the inputs used in the estimation of ECL. Lastly, another point of concern is the role of expert judgement in the treatment of low-default portfolios.

[12] EBA Guidelines 2017/06 on credit institutions’ credit risk management practices and accounting for expected credit losses.

Abbreviations

CET1	Common Equity Tier 1	**IFRS**	International Financial Reporting Standard
EAD	exposure at default	**IRB**	internal ratings-based
EBA	European Banking Authority	**LGD**	loss given default
ECB	European Central Bank		
ECL	expected credit losses	**PD**	probability of default
GDP	Gross Domestic Product	**SA**	standardised approach
FLI	forward-looking information	**SICR**	significant increase in credit risk
FVOCI	fair value through other comprehensive income	**SPPI**	solely payment of principal and interest
IAS	International Accounting Standard	**SSM**	Single Supervisory Mechanism

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