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Report

On results from the EBA impact assessment of IFRS 9

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Abbreviations

bps	Basis points
CET1	Common Equity Tier 1
CRAs	Credit risk adjustments
EAD	Exposure at default
ECL	Expected credit losses
FVOCI	Fair value through other comprehensive income
FVPL	Fair value through profit or loss
GCRAs	General credit risk adjustments
IAS 39	IAS 39 – Financial Instruments: Recognition and Measurement
IFRS 9	IFRS 9 – Financial instruments
IRB	Internal ratings-based
LGD	Loss given default
PD	Probability of default
RWAs	Risk-weighted assets
SA	Standardised approach
SCRAs	Specific credit risk adjustments
SPPI	Solely payment of principal and interest

Executive summary

In the context of the forthcoming implementation of IFRS 9 in the European Union (EU), the European Banking Authority (EBA) launched an impact assessment of the standard on a sample of approximately 50 institutions across the European Economic Area (EEA) in January 2016.¹

This is own-initiative project from the EBA and is not linked to the adoption process of the standard taking place at the legislative level. The objectives of this exercise were to help the EBA understand the estimated impact of IFRS 9 on regulatory own funds and to support the EBA in assessing the interaction between IFRS 9 and other prudential requirements and the way in which institutions are preparing for the application of IFRS 9.

The EBA acknowledges that institutions are in the process of developing the necessary processes, models and capabilities for the implementation of IFRS 9. Therefore, institutions were invited to provide information on a best-efforts basis.

Content of the report

Part 1 (Introduction) of the report includes background information on this exercise, such as the objective of the exercise and the limitations of the responses collected. Part 2 (Main observations) of the report sets out the main observations from the EBA’s analysis of the information provided by the sample of banks in response to the EBA exercise and includes recommendations relevant to some of these observations.² Part 3 (Areas of further work – The way forward) describes possible future actions to be launched based on the information collected in this exercise. Overall, at the time the survey was conducted (April 2016)—which was based on banks’ estimations as of 31 December 2015—banks were at an early stage of preparation for the implementation of IFRS 9 and the information provided reflects this.

When providing this information, banks have made several assumptions and simplifications that do not necessarily represent their finalised IFRS 9 methodology. In addition, the portfolios of banks may change when IFRS 9 is first applied and the state of the economy may also be different at that time. For all these reasons, the observations in this report are indicative of the main trend in the EU banking sector at the time the exercise was performed, and the impact of IFRS 9 may be different when IFRS 9 is first applied.

That said, the EBA will closely monitor the different steps of implementation by EU institutions for IFRS 9. As part of that process, the EBA is launching a second impact assessment exercise based on the experience gained in the first exercise.

¹ This is also included in the EBA work programme: <http://www.eba.europa.eu/about-us/work-programme/current-work-programme>.

² The recommendations provided in the report are not meant to be exhaustive.

1. Main observations of the impact assessment exercise

At a high level, implementation efforts are ongoing (development of processes, systems, models and data) and are expected to be constantly evolving until at least the initial application of IFRS 9.

The response rate to the exercise was also reflective of this fact. All banks in the sample provided qualitative information on the estimated impact of IFRS 9 by answering 34 questions on some of the main elements of IFRS 9 implementation of particular interest to the EBA. Most respondents also provided information on almost all the quantitative questions of the exercise (which focused on some financial statements data and the impact on own funds).

1.1 Qualitative aspects

The main qualitative observations highlighted from this exercise are the following:

- The smaller banks surveyed are lagging behind in their preparation compared to larger banks in this sample, as they are usually at an early stage of IFRS 9 implementation. This may be because the scale of IFRS 9 implementation for smaller banks is generally relatively smaller than for larger banks and/or because the smaller banks may have less available resources to invest in this implementation. However, the EBA believes that it is important that banks (both large and small) do not underestimate the work involved in the implementation of IFRS 9 and, in this regard, adequate time is essential.
- Based on the responses received, the involvement of some key stakeholders in IFRS 9 implementation seems limited at the current stage. As the implementation of IFRS 9 requires collaboration between different departments within an entity, key functions from the business should be involved in this project, including credit risk experts, audit committees and the board of directors. Ownership of the project by senior management and the allocation of sufficient resources to it are necessary to ensure timely and high-quality implementation of IFRS 9.
- Many respondents plan to perform parallel runs to test the implementation of IFRS 9, but it seems that this testing may, in some cases, be more limited than originally envisaged due to there being insufficient time between the completion of the building of the systems and initial application of IFRS 9. Banks need to be careful when reducing their parallel-running plans, as a parallel run is considered good practice in understanding and explaining the new IFRS 9 estimates.
- Banks are generally looking (up to the extent possible) to leverage off existing definitions, processes, systems, models and data used for regulatory and credit risk management purposes in order to implement IFRS 9 impairment requirements, although new models and/or adjustments to existing models will be necessary. It is important, however, that the existing definitions, processes, systems, models and data are used only if and to the extent that they are fit for the purposes of IFRS 9, which may not always be the case.

- Data quality and availability are the most significant challenges for banks responding to the survey and they expect to use different sources of data, such as internal sources (for instance, information already used in IRB models or in other exercises, including the stress test) and external sources (for instance, rating agencies).
- Overall, the impact of the change in classification and measurement requirements does not seem very significant for most banks. The impact could depend on the type of business carried out and the products held by a bank, as those banks with more plain vanilla products are expected to have fewer challenges in the implementation of IFRS 9 classification and measurement requirements.
- The interpretation and application of some key elements of IFRS 9 impairment requirements—such as the significant increase of credit risk—are challenging and have to be finalised in many cases. The EBA guidelines on credit risk management practices and accounting for ECL (the EBA guidelines on ECL)³—which introduce into the EU the existing Basel Committee on Banking Supervision (BCBS) ‘Guidance on credit risk and accounting for ECL’⁴—will provide guidance to banks on addressing these challenges and on the overall implementation of IFRS 9 as necessary.
- Available practical expedients of IFRS 9 (simplifications) will be used by banks. Some of these may be used more than others (also depending on the type of portfolio). In addition, most banks will use the 30 days past due criterion, although not usually as a primary indicator of significant increase in credit risk. If the use of practical expedients creates bias in the estimation of ECL—which, for example, is what using a 30 days past due test to identify significant increases in credit risk can do—credit institutions should consider the need to make adjustments to counter that bias and that these adjustments are subject to appropriate governance processes in order to ensure that the objectives of IFRS 9 are met.
- 75% of the banks included in the survey anticipate that IFRS 9 impairment requirements will increase volatility in profit or loss. Respondents mentioned that this was mainly due to the ‘cliff effect’ when moving exposures from stage 1 to stage 2 (from 12-month ECL to lifetime ECL), due to the movement between stages 1 and 2 and due to the inclusion of forward-looking information that will need to be re-assessed at each reporting period in the ECL estimation. However, 16% of the banks do not anticipate that the IFRS 9 impairment requirements will significantly increase the volatility in profit or loss compared to IAS 39, as the ECL model under IFRS 9 may lead to more gradual recognition of losses compared to the level of losses recognised under IAS 39 (which was based on an incurred loss model). Other banks (9%) are not able to assess the impact at the current stage.

³ The draft EBA guidelines on ECL are available at <https://www.eba.europa.eu/-/eba-consults-on-guidelines-on-credit-risk-management-practices-and-accounting-for-expected-credit-losses>. The period for public consultation ended on 26 October 2016. The EBA aims to finalise the proposed guidelines during the first quarter of 2017.

⁴ <http://www.bis.org/bcbs/publ/d350.htm>.

1.2 Quantitative aspects

Respondents provided best-efforts estimates of the quantitative impact of IFRS 9 on selected financial and regulatory capital metrics at the time the exercise was conducted. The exercise included simplifications and, in some instances, respondents provided estimates in the form of an estimated range of impact (rather than an absolute impact).

Quantitative estimates should be considered taking into account the limitations at the time of conducting this exercise, as mentioned above. These limitations mainly relate to the fact that banks are at an early stage of preparation for the implementation of IFRS 9. In this regard, several assumptions and simplifications have been made to provide an estimated quantitative impact. Some banks also mentioned that their estimates for responding to the survey were not necessarily subject to the usual (internal and/or external) validation processes (as it would be the case for established financial reporting processes) and that the available resources—such as data and design of models—were limited at the current stage of implementation of IFRS 9. In addition, it should be acknowledged that there could be confidence intervals in the estimates performed in this exercise. It is also acknowledged that the state of the economy may be different when IFRS 9 is initially applied compared to the state of the economy at the time of conducting this assessment. Hence, the observations in this report are indicative of the main trend in the EU banking sector at the time the exercise was performed, and the impact of IFRS 9 may be different when IFRS 9 is first applied.

On this basis, the following aspects were observed:

- The total estimated impact of IFRS 9 is mainly driven by the impairment requirements and, to a lesser extent, by the classification and measurement requirements of IFRS 9. The main impact seems to be driven by the estimation of lifetime ECL for stage 2 exposures (i.e. exposures that have experienced a significant increase of credit risk but are not defaulted).
- The estimated change in provisions varies from portfolio to portfolio—and, therefore, across entities—and different factors could influence the impact of IFRS 9 in percentage terms on own funds, such as: the existing level of provisions under IAS 39; the bank's current level of own funds; or the use of a SA or an IRB approach for measuring credit risk for prudential purposes (for SA banks, any increase in provisions under IFRS 9 will be directly recognised in CET1, while for IRB banks, the impact would depend on the excess/shortfall situation).
- The reclassification of financial instruments between categories may also have an impact on own funds, but this is limited in most cases due to the banks' business models and the composition of their balance sheets (which mainly includes lending activities through loans and advances to households and corporates followed by debt securities).

- The estimated increase of provisions compared to the current levels of provisions under IAS 39 is 18% on average and up to 30% for 86% (75th percentile⁵) of respondents.⁶
- In terms of the estimation of the total quantitative impact of IFRS 9, CET1 and total capital ratio are estimated to decrease, on average, by 59 bps and 45 bps respectively. CET1 and total capital ratio are estimated to decrease by up to 75 bps for 79% of respondents (75th percentile). However, as is the case when using statistical metrics, it should be noted that some of the estimates relating to the total sample of respondents were different from the above-mentioned estimates. Other metrics (median⁷ and weighted average) used for the analysis have been included in the table at the end of part 2 of this report.⁸
- It should be reiterated that this is only a preliminary best-efforts estimate. The EBA is conducting a second exercise to assess the impact, for which it expects more reliable and precise information to be provided by respondents as a result of their ongoing efforts to implement IFRS 9.

2. Areas of further work – The way forward

Based on the information collected in this exercise, the report includes proposals for the next steps that could cover the following three main areas:

- Launching of the second EBA exercise on the impact assessment of IFRS 9, which builds on the experience of the current exercise;
- Engagement of the EBA with banks and auditors in an ongoing dialogue on the implementation issues observed in this exercise, and regarding which banks are encouraged to continue their efforts towards the high-quality implementation of IFRS 9;
- Considering additional regulatory guidance or recommendations with regard to the outcome of the interaction between the existing prudential requirements and the applicable accounting framework, including aspects related to any transitional arrangements for the application of the revised accounting frameworks, clarifications regarding the existing regulatory technical standards (RTS) for specifying the calculation of SCRAs and GCRAs,⁹ and the interaction between accounting and prudential credit risk calculations. The EBA welcomes further discussion with stakeholders on these aspects during the coming months and will continue monitoring IFRS 9 after it starts to be applied.

⁵ The value of the 75th percentile represents the value below which 75% of the data lies. For example, if the value of the 75th percentile is 90%, then 75% of respondents have reported a value up to 90% and 25% a value above 90%.

⁶ Averages indicate an approximation of the estimated possible impact, which should be considered together with the other quantitative metrics provided in this report.

⁷ 50th percentile.

⁸ This table includes a summary of the estimated quantitative impact of IFRS 9 for the sample and information on the assumptions used to calculate the averages.

⁹ <http://www.eba.europa.eu/regulation-and-policy/credit-risk/draft-regulatory-technical-standards-on-the-calculation-of-credit-risk-adjustment>.

1. Introduction

Background

1. This report is an own-initiative project from the EBA¹⁰ following the International Accounting Standards Board (IASB) publication of IFRS 9 in July 2014 and the planned endorsement of IFRS 9 in the EU (which replaces the current requirements of IAS 39). This report is not related to the endorsement of IFRS 9 in the EU.
2. The EBA welcomes the move from an incurred loss model to an ECL model under IFRS 9 and the timely adoption of IFRS 9 in the EU, as mentioned in its advice to the European Financial Reporting Advisory Group (EFRAG) on the endorsement of this standard.¹¹ IFRS 9 is, overall, an improvement compared to IAS 39 in terms of the accounting for financial instruments by banks. The changes in credit loss provisioning should contribute to addressing the G20's concerns about the issue of 'too little, too late' in the recognition of credit losses, as well as improve the accounting recognition of loan loss provisions by incorporating a broader range of credit information. IFRS 9 is, therefore, expected to address some banking prudential concerns and contribute to financial stability in the EU.
3. A significant number of banks in the EU apply IFRS, as these are incorporated into the EU legal framework through EU regulations in accordance with the procedures set out in Regulation (EC) No 1606/2002. In particular, besides the mandatory application of IFRS to the consolidated accounts of listed entities in accordance with Regulation (EC) No 1606/2002, Member States may require or permit the application of IFRS in the following cases: a) in consolidated financial statements of banks whose securities are not listed in regulated markets, b) in the annual financial statements of banks (irrespective of being listed or not in regulated markets),¹² and c) for supervisory reporting (in accordance with Article 24 of Regulation (EU) No 575/2013 of the Capital Requirements Regulation (CRR), where financial statements are prepared under national generally accepted accounting principles (GAAP)).
4. IFRS 9 will introduce a number of changes for banks, and the EBA is aware of several interactions between IFRS 9 and the prudential regulatory framework that need to be

¹⁰ This is also included in the EBA work programme: <http://www.eba.europa.eu/about-us/work-programme/current-work-programme>.

¹¹ <http://www.eba.europa.eu/documents/10180/943157/Letter+to+EFRAG+Board+on+IFRS+9+endorsement.pdf>.

¹² Based on an EBA stock-take exercise conducted in 2016 with information from 26 Member States, all these Member States permit or require the use of IFRS in the consolidated financial statements of credit institutions besides the mandatory use of IFRS under the IAS Regulation. Most Member States (18 out of 26) permit or require the use of IFRS in the individual financial statements of listed and non-listed financial institutions (mandatory use of IFRS is mainly required for the individual financial statements of listed credit institutions). Fewer Member States (5 out of 26) either require or permit the use of IFRS for prudential purposes (Article 24 of the CRR).

analysed further as the quantitative impacts of IFRS 9 become more precise. In this regard, the EBA launched an exercise addressed to a sample of banks at the end of January 2016 in order to obtain an understanding of the impacts of the application of IFRS 9 on institutions across the EEA, as the date of application of IFRS 9 in the EU is approaching.

5. This exercise was the first stage for assessing the impact of IFRS 9 on banks in the EU. The EBA is now launching the second stage of the exercise. This second stage will help the EBA better understand some specific areas—following the analysis of the information collected in the first exercise—as banks further develop their methodologies towards the implementation of IFRS 9 and provide additional disclosures in the financial statements for the estimated impact. It will also allow the EBA to have more up-to-date and better information on the possible impacts of IFRS 9 and its interaction with prudential requirements, which is necessary to support policymaking on related capital issues.

Objective of the first exercise

6. The EBA acknowledged when launching this exercise (and this was confirmed when analysing the responses of banks) that institutions are in the process of developing the necessary capabilities for the implementation of IFRS 9 (such as processes, systems, models and data) and hence that the quality of the information provided in this exercise may improve in the future. Therefore, in the first exercise, only preliminary views were sought and an analysis was performed on the basis of that.
7. The EBA anchored the analysis of the responses collected on the estimated impact of IFRS 9 on own funds (including the interaction between IFRS 9 and other prudential requirements) and the implementation issues related to IFRS 9.

Sample

8. The sample consisted of 58 institutions across Member States, and the starting point was the institutions included in the key risk indicators (KRI) sample considered by the EBA for the preparation of its regular risk assessment reports on risks and vulnerabilities in the EU banking sector. The sample selected is representative of the banking sector in the EU and consists of different institutions in terms of size, business model and risk profile.
9. All 58 banks have provided qualitative information and 39 banks (67%) have also provided information on almost all the quantitative data required in the templates. Fifteen banks (26%) have provided part of the quantitative information required and four banks (7%) were not able to provide any quantitative data at this stage.¹³ In particular, 47 banks (81%) were able to estimate the total impact of IFRS 9 on CET1 ratio (and total capital ratio).

¹³ These banks mentioned that they face a high level of uncertainty during their ongoing implementation efforts and hence are unable to provide estimates of sufficient quality to provide a meaningful estimation of the impact of IFRS 9.

10. In terms of the size of the banks in the sample, the total assets of the banks in the sample range from approximately EUR 10 billion to above EUR 2 000 billion. The 75th percentile¹⁴ of respondents has total assets of approximately EUR 660 billion. Most of the banks in the sample (91%) are identified as either Global Systemically Important Institutions (G-SIIs) (60%) or Other Systemically Important Institutions (O-SIIs) (31%). For the purpose of this analysis, it is assumed that banks with total financial assets below EUR 100 billion are smaller banks compared to the rest of the sample. These smaller banks are mainly O-SIIs (14 out of 18 smaller banks) and a few are neither G-SIIs nor O-SIIs (4 out of 18 smaller banks).
11. Most of the banks in the sample use both a SA and an IRB approach for measuring RWAs for credit risk, except for some banks that only use the SA (9 banks, 7 out of which have submitted quantitative data).
12. In terms of the countries represented in the sample, 20 countries are represented in total with regard to the qualitative responses and 19 countries are represented with regard to the quantitative responses.

Basis for responding to the exercise

13. The information was provided at the consolidated level of each institution in the sample under the prudential scope of consolidation.
14. Institutions were invited to provide data on a best-efforts basis and were also informed that any publication of the information received will be on an aggregated basis. Individual information received from each institution will remain confidential.
15. Institutions were to consider current regulation, business model, asset composition and economic conditions at the date of conducting this exercise. For the information relating to the impairment requirements, respondents could also take into account the application of the BCBS 'Guidance on credit risk and accounting for ECL'.¹⁵ The EBA has published, on 26 July 2016, a consultation paper on draft guidelines on credit risk management practices and accounting for ECL (EBA guidelines on ECL). The paper aims at implementing the BCBS guidance in the EU. The draft EBA guidelines are expected to be finalised during the first quarter of 2017.¹⁶

Structure of the exercise

16. The exercise included a qualitative section and a quantitative section.

¹⁴ The value of the 75th percentile represents the value below which 75% of the data lies. For example, if the value of the 75th percentile is 90%, then 75% of respondents have reported a value up to 90% and 25% a value above 90%.

¹⁵ <http://www.bis.org/bcbs/publ/d350.htm>.

¹⁶ <https://www.eba.europa.eu/-/eba-consults-on-guidelines-on-credit-risk-management-practices-and-accounting-for-expected-credit-losses>

a. Qualitative questions

17. Respondents were invited to provide specific responses to 34 qualitative questions at a sufficient level of detail, avoiding boilerplate answers and the repetition of applicable requirements. The questions in the qualitative section related to the following: a) IFRS 9 project status and governance; b) classification and measurement; c) impairment requirements; d) hedge accounting; e) regulatory own funds (and interaction of IFRS 9 with other prudential requirements, such as liquidity); and f) other.

b. Quantitative questions

18. The questions of the quantitative section included an estimate of some financial statements' data and related capital adequacy figures, assuming that IFRS 9 was applied at the reference date. These estimates were differentiated in terms of changes related to: the impact on Balance Sheet from a) classification and measurement and b) impairment; and c) the impact on regulatory own funds (from classification and measurement, impairment and other impacts from IFRS 9, for instance hedge accounting or interaction with prudential requirements).

19. The reference date of the data was 31 December 2015 and, in a few cases where data was not available for that reference date (6 banks), the latest audited data for a financial year were used. Data was to be submitted in euro using official foreign exchange reference rates (European Central Bank (ECB) source).¹⁷

20. In some quantitative questions, it was required that, instead of providing the amount in euro, the estimated range of change or a percentage should be provided instead (having regard to the fact that the answers were best estimates).

21. Where the data necessary to estimate the impact was not available, institutions were requested to provide explanations as to why the estimation was not possible.

22. Respondents were to provide the relevant information on the estimated impact of the application of IFRS 9 using the current data under IAS 39 as a starting point. Institutions were to provide information as if IFRS 9 were applied at that reference date instead of IAS 39 (with some exceptions).¹⁸ In estimating ECL, institutions were to use reasonable and supportable forward-looking information available at the time of completing the exercise, and also to consider the prudential framework at the time the exercise was launched.

¹⁷ <http://sdw.ecb.europa.eu/browse.do?node=2018794>.

¹⁸ In particular, for the impact of the IFRS 9 classification and measurement requirements, the information provided was to be based on the IAS 39 impairment requirements. Therefore, institutions did not need to estimate the impact of IFRS 9 impairment requirements. For the impact of the IFRS 9 impairment requirements, the information provided was to be based on IFRS 9 impairment requirements and the institutions did not need to consider the reclassification of assets among categories due to IFRS 9.

Main assumptions and caveats

23. Respondents mentioned several assumptions and issues to be taken into account when analysing the qualitative and quantitative information provided. Indeed, the responses of the banks to this exercise are preliminary estimates. This confirmed the EBA's understanding that banks are currently in the process of developing the necessary capabilities for the implementation of IFRS 9 (such as processes, systems, models and data) and that the quality of the information provided in this exercise should improve in the future.
24. Most of the banks that provided additional information on the assumptions used for quantitative estimates mentioned that the IFRS 9 methodology used for the purposes of the exercise is on a best-efforts basis and does not necessarily represent their finalised IFRS 9 methodology.
25. In addition, certain simplifying assumptions were undertaken in order to complete the exercise (for example, the limited use of forward-looking information or less developed scenarios), which may not be fully consistent with the objectives of IFRS 9. Implementation efforts are ongoing (processes, systems, models and data) and are expected to evolve until at least the initial application of IFRS 9. Some banks also mentioned that their estimates for responding to the survey were not necessarily subject to the usual (internal and/or external) validation processes (as would be the case for established financial reporting processes) and that the available resources—such as data and design of models—were limited at the current stage of implementation of IFRS 9. In addition, it is acknowledged that there can be confidence intervals around the point estimates used to perform this assessment.
26. Lastly, these estimates also depend on the existing economic environment (in which the business model of a bank is applied) at the time this assessment was performed, but this may change before the implementation of IFRS 9. Therefore, the observations in this report are indicative of the main trend in the EU banking sector at the time the exercise was performed and the impact of IFRS 9 may be different when IFRS 9 is first applied.

2. Main observations

27. Taking into account the limitations of this exercise (as previously mentioned), the following main observations can be made from the analysis of the responses received.

Qualitative assessment

IFRS 9 project status and governance

Degree of preparation

28. Banks were asked to explain what phase of implementation of IFRS 9 they were at (differentiating between early-design, advanced-design, building and testing).

29. **Most¹⁹ banks are in a design phase for both classification and measurement and impairment and only a few banks are in the building phase.²⁰** There was no bank in the sample in the testing phase of IFRS 9. This is an important observation, as it affects the accuracy of the estimated impact of IFRS 9 by a bank and the outcomes of the EBA exercise respectively.

30. In addition, **most of the smaller institutions of the sample (14 out of 18 smaller banks) are at an early-design stage of implementation for both classification and measurement and impairment. Larger banks tend to be more advanced in the implementation of IFRS 9.** However, there are some larger banks of the sample (11 out of 40 larger banks) that are at an early-design stage of implementation for both classification and measurement and impairment. This might be because the scale of IFRS 9 implementation for smaller banks is generally relatively smaller than for larger banks and/or because the smaller banks may have less available resources to invest in the implementation of IFRS 9 (such as the lack of historical data and modelling capabilities, as well as limited IT and human resources).

31. Almost half of the banks that participated in the survey are planning to keep applying the current IAS 39 hedge accounting requirements;²¹ therefore, they will not be applying IFRS 9 hedge accounting requirements. There is a higher proportion of smaller banks than larger banks planning to apply IFRS 9 hedge accounting requirements. This may be because larger

¹⁹ 'Most' means more than 50% of respondents to the question unless specified otherwise.

²⁰ With regard to classification and measurement, 29 banks were in an early-design phase, 21 banks were in an advanced-design phase and 8 banks in a building phase. On impairment, 27 banks were in an early-design phase, 19 banks were in an advanced-design phase and 12 banks in a building phase.

²¹ Entities may choose as an accounting policy to continue to apply the hedge accounting requirements of IAS 39 instead of the requirements of IFRS 9, and this shall apply to all hedging relationships of entities (IFRS 9 7.2.21). In addition, as the IASB has not yet completed its project on the accounting for macro hedging, the exception in IAS 39 for a fair value hedge of an interest rate exposure of a portfolio of financial assets or financial liabilities continues to apply under IFRS 9 (paragraph 5.2.3).

banks tend to make greater use of the possibilities in IAS 39 for macro hedge accounting, which some respondents believe are not available in IFRS 9. Hence, the decision regarding which hedge accounting requirements will be applied (IAS 39 or IFRS 9), as well as the extent to which hedge accounting is used for some banks, is also subject to developments related to the dynamic risk management project of the IASB.²²

EBA recommendation

The EBA is concerned that some banks are at an initial stage of implementation for IFRS 9. In addition, the smaller banks of the sample are lagging behind in their preparation compared to larger banks in this sample. The EBA understands that this might be because the scale of the IFRS 9 project implementation is generally relatively smaller than for larger banks, but it also understands that this would be challenging for some smaller banks that may have less available resources to invest in the implementation of IFRS 9. It is important that banks (both large and small) do not underestimate the work involved in the implementation of IFRS 9. For example, databases need to be built or acquired, forward-looking scenario building needs to be developed or acquired, and governance around the whole process needs to be developed and tested. Hence, time is of essence in the implementation of IFRS 9.

Involvement of departments and responsibilities

32. Banks were asked to provide information on the degree and nature of involvement of key stakeholders in IFRS 9 implementation—i.e. the board of directors, audit committee, senior management and external auditors—and to explain which departments are involved in the implementation of IFRS 9 and how they interact.

33. **Senior management is the most actively involved in the implementation of IFRS 9, followed by the external auditors** who are consulted or informed about decisions taken by the banks. However, the involvement of the board of directors and the audit committee is more limited or, in some cases, they have not been mentioned in the response (which may signal that they are not involved or are involved in a very limited way). Very few banks have reported a close level of engagement with all four stakeholders.

34. **Risk and Finance are involved in the implementation of IFRS 9 for most banks.** The IT function is also significantly involved. However, it is understood that, due to the differences in the size, types of activities, business models and the sophistication of banks, different approaches may be applied for the project management of IFRS 9.

35. **Most banks have created a Steering Committee for the implementation of IFRS 9**, which consists (at a minimum) of representatives from both Risk and Finance. Who is responsible for the implementation of IFRS 9 varies across banks. Some banks mentioned that the

²²<http://www.ifrs.org/Current-Projects/IASB-Projects/Financial-Instruments-A-Replacement-of-IAS-39-Financial-Instruments-Recognition/Phase-III-Macro-hedge-accounting/Pages/Phase-III-Macro-hedge-accounting.aspx>.

Steering Committee is responsible (and, in some cases, Finance is mainly involved in classification and measurement and Risk in impairment). In other banks, the responsibility is either jointly shared by Risk and Finance or only that of Finance. In certain banks, the responsibility is shared between different departments for different elements of the implementation of IFRS 9.

EBA recommendation

Based on responses received, the involvement of some key stakeholders in IFRS 9 implementation seems limited at the current stage of implementation. As the implementation requires the collaboration of different departments within an entity, key functions from the business should be involved in this project, including credit risk experts, audit committees and the board of directors. A clear allocation of roles and responsibilities for IFRS 9 implementation across the different departments and individuals of a bank is also necessary to ensure efficient and effective implementation. Ownership of the project by senior management and the allocation of sufficient resources to it are necessary to ensure timely and high-quality IFRS 9 implementation.

Risks in IFRS 9 implementation

- 36. For most banks, data quality is the major risk.** It will be necessary to ensure reliable data, to manage high volume and complex information, as well as to source historical information. Other risks include model validation and the reconciliation of credit risk management and financial reporting data. Audit trail has not been considered a major risk by most banks at the current stage. This may be because banks are currently implementing IFRS 9 and audit trail is more a future concern than a current one.
- 37. Most banks plan to undertake a parallel run of IAS 39 and IFRS 9 before the initial application of IFRS 9 in 2018. This is especially with regard to the impairment requirements of IFRS 9 and less for the classification and measurement requirements of IFRS 9.** With regard to hedge accounting, few banks have reported that they intend to carry out a parallel run, but it should also be taken into account that almost half of the banks will continue to apply the IAS 39 requirements on hedge accounting.
- 38. The duration of the parallel run for impairment will vary across banks, ranging from less than 6 months to up to 1 year.** It should also be noted that, although respondents were asked to explain when they plan to do a parallel run, many banks (38%) have not specified the duration of the parallel run and some banks (19%) do not plan to undertake any parallel runs for impairment before the initial application of IFRS 9. Plans to perform parallel runs on impairment models and methodologies for a full year are mentioned by some banks (19%). These are, in the vast majority, larger banks that are in either the design or the building phases of IFRS 9 for impairment. For classification and measurement, in most cases, parallel runs are planned to be performed at a later stage than those for impairment, possibly between 3 to 6 months before the initial application of IFRS 9.

EBA recommendation

Most of the banks have not considered model validation as a major risk of IFRS 9 implementation. As part of an effective credit risk management framework, credit institutions should establish robust policies and procedures to appropriately validate the models that will be used to measure ECL in order to ensure the accuracy and consistency of these models in assessing credit risk and measuring ECL. This issue is particularly important for banks that currently have limited resources for the implementation of IFRS 9 (such as smaller banks or banks using the SA) and that may not be able to leverage off existing capabilities to implement IFRS 9, as these banks will need to ensure the accuracy and consistency of models used for assessing credit risk and measuring ECL.

Many respondents plan to perform parallel runs to test the implementation of IFRS 9, but it seems that this testing may, in some cases, be more limited than originally envisaged due to there being insufficient time between the completion of the building of the systems and initial application of IFRS 9. Banks need to be careful when reducing their parallel-running plans, as this process is considered good practice in improving the quality of implementation of IFRS 9 and understanding the differences between the two sets of rules. This process should contribute to applying effective credit risk management and providing meaningful disclosures to the public.

Classification and measurement²³

39. Overall, the impact of the change in classification and measurement requirements does not seem very significant for most banks. Having said that, some banks are affected more, perhaps mainly because the special features of some of the instruments they hold involve cash flows that do not meet the SPPI²⁴ assessment.

40. Under IFRS 9, the measurement basis for financial assets—and, therefore, the balance sheet structure—is likely to remain broadly the same; thus, amortised cost will, in most cases, be the most relevant category (notwithstanding the changes in provisions due to IFRS 9 impairment requirements). **However, in limited cases, financial assets could be reclassified mainly from amortised cost or FVOCI under IAS 39 to FVPL under IFRS 9.**

41. Under IFRS 9, the measurement basis of financial liabilities is likely to remain similar to the one under IAS 39 (i.e. the amortised cost).

42. It is also worth noting that many banks have not finalised their IFRS 9 classification and measurement assessment, so the actual impact might be different when IFRS 9 is implemented.

²³ In summary, under IAS 39, financial assets were classified into four categories: a) FVPL (measured at fair value with changes in fair value recognised in profit or loss), b) held to maturity (measured at amortised cost), c) loans and receivables (measured at amortised cost), and d) available for sale (measured at fair value with changes in fair value recognised in other comprehensive income). Under IFRS 9, financial assets will be classified and measured according to three categories: a) FVPL, b) amortised cost, and c) FVOCI.

²⁴ The SPPI assessment relates to the assessment of whether the cash flows of a financial instrument mainly represent principal and interest.

Main challenges for classification and measurement

43. More challenges were identified by banks with regard to the SPPI assessment than the business model²⁵ assessment of IFRS 9.

- **In terms of the SPPI assessment**, some of the main challenges mentioned by banks are: (i) the need to perform an individual assessment for contracts with non-standardised terms (which may be burdensome and time-consuming); (ii) the benchmark test²⁶ (as there are instruments whose interest rates are reset with a different frequency to the tenor of the interest rate or where average or lagged rates are used); and (iii) the assessment of the cash flows of products with more special features (such as products with early redemption clauses and contractually linked instruments²⁷ where it is not clear if they will meet the SPPI assessment, although these challenges are anticipated by the IFRS 9 requirements);
- **In terms of business model assessment**, one challenge mentioned by banks is the clarification of the concept of ‘infrequent and insignificant sales’ in IFRS 9²⁸—which is an area where judgement will be applied—in order to determine the appropriate classification and measurement of assets;
- **Therefore, the impact could depend on the type of business carried out and the products held by a bank, as those banks with more plain vanilla products are expected to have less issues in determining whether their portfolios are SPPI compliant or not.**

Interaction with liquidity requirements

44. Most banks do not expect that the application of the prudential requirements on liquidity will affect the classification of their assets in the different IFRS 9 categories for

²⁵ This is a business model assessment related to the assessment of whether the entity has specified that it holds the asset to only collect the cash flows or to collect the cash flows and sell it.

²⁶ This refers to the need to assess the contractual terms of the financial asset if they give rise, on specified dates, to cash flows that are SPPI on the principal amount outstanding (IFRS 9 4.1.2(b))—i.e. being consistent with a basic lending arrangement (IFRS 9 B4.1.7A) whose interest typically provides consideration for the time value of money and credit risk or other basic lending risks. In the case of an instrument whose interest rate periodically resets but the frequency of that reset does not match the tenor of the interest rate (for example, the interest rate resets every month to a 1-year rate) or if a financial asset’s interest rate is periodically reset according to an average of particular short- and long-term interest rates, an entity will need to assess the cash flows of this instrument against an instrument with identical credit risk but whose interest rate is reset to match the tenor of the interest rate.

²⁷ These are transactions in which an issuer may prioritise payments to the holders of financial assets using multiple contractually linked instruments that create concentrations of credit risk (tranches). Each tranche has a subordination ranking that specifies the order in which any cash flows generated by the issuer are allocated to the tranche. In such situations, the holders of a tranche have the right to payments of principal and interest on the principal amount outstanding only if the issuer generates sufficient cash flows to satisfy higher-ranking tranches (IFRS 9 B4.1.20). Under IFRS 9 B4.1.21-26, entities should follow specific requirements to assess if their exposure includes cash flows that represent only principal and interest so as to measure these exposures at amortised cost.

²⁸ This refers to the requirement of IFRS 9 (paragraph B.4.1.3B) according to which, in order for sales to be consistent with a business model whose objective is to hold financial assets in order to collect contractual cash flows, those sales should be infrequent (even if significant in value) or insignificant in value both individually and in aggregate (even if frequent).

classification and measurement. This is relevant mainly to those assets for which a bank needs to regularly demonstrate their liquidation vis-à-vis meeting the IFRS 9 requirements for classification and measurement of the same assets (for example, some banks mentioned that liquidation could be met through their assets classified in the FVOCI category).

Estimated reclassifications of financial assets

45. In terms of the possible reclassifications of financial instruments due to IFRS 9, **banks estimate that there will be reclassifications in limited cases and possibly between all categories** (FVPL, FVOCI and amortised cost), but the impact of these reclassifications does not seem very significant for the vast majority of banks. Reclassifications have been estimated as follows:

- **More commonly, banks estimate movements towards FVPL (from amortised cost or FVOCI²⁹ under IAS 39) due to instruments failing the SPPI assessment** (for example, investments in funds, or loans or debt securities with specific characteristics including syndicated loans and contractually linked instruments). Some banks (19%) intend to reclassify equity instruments that are currently classified in FVOCI under IAS 39 as FVPL and some have mentioned that this is because of the IFRS 9 prohibition on recycling gains and losses for those instruments in profit or loss.
- A few banks estimate movements towards amortised cost or FVOCI from the FVPL or from FVOCI under IAS 39 to amortised cost and vice versa. This is mainly due to the outcome of the business model assessment where, for instance, the level of sales expected is such that it is considered appropriate to classify some debt instruments at FVOCI or at amortised cost.

46. The vast majority of banks do not anticipate any significant change in the use of the fair value option under IFRS 9 compared to their current use under IAS 39, although this part of the portfolio of instruments is less significant for the banks in the sample. For example, for the 75th percentile of respondents, the financial assets under the fair value option are only 4% of the total financial assets and, for the average, this is 3% of total financial assets.

²⁹ The reference to FVOCI under IAS 39 is used to refer to the available-for-sale category under IAS 39.

EBA recommendation

Overall, the impact of the change in classification and measurement requirements does not seem very significant for most banks. The impact could depend on the type of business carried out and the products held by a bank, as those banks with more plain vanilla products are expected to have less issues in determining whether their portfolios are SPPI compliant or not.

Banks have identified several challenges with regard to the SPPI and the business model assessment. These are areas that the EBA expects banks to work on during the following months in order to address these challenges.

Impairment

47. Banks were still in the process of developing aspects of their new IFRS 9 ECL methodologies at the time the EBA exercise was conducted. As a result, some of the responses to this exercise were less specific or, to some extent, tentative. By the time of the second EBA exercise, the EBA expects banks to be more advanced in the development of their methodologies and, therefore, to be able to provide more detailed and accurate responses.

Key elements and challenges in the implementation of IFRS 9 impairment requirements³⁰

48. The use of lifetime ECL for calculating the loss allowance when there is a significant increase of credit risk (stage 2) is the main source of change in the amount of provisions that results from the move to IFRS 9. In addition, the need to recognise provisions against a wider range of assets under IFRS 9 compared to IAS 39 has been highlighted as an important reason for the differences in loss allowances (IFRS 9 stage 1 allowances will need to be calculated for performing exposures and off-balance-sheet exposures).

49. The availability of data and the availability of resources are two of the main issues and challenges of IFRS 9 impairment implementation. Both of these issues are addressed in the draft EBA guidelines on ECL.

- **In terms of data availability,** the main issue described was the availability of historical data for IFRS 9 purposes and, in particular, determining the credit risk (as reflected in the PD or rating) at origination for exposures that originated a long time ago or before the bank started using an IRB model and exposures for which there could be limited data or

³⁰ In summary, under IAS 39, an incurred loss model is applied, which requires the existence of objective evidence of impairment at each reporting date before the recognition of impairment losses. In addition, different impairment models are applied for different IAS 39 categories of assets. The IFRS 9 impairment model is based on expected losses and applies to all financial instruments that are subject to impairment (those at amortised cost and at FVOCI). ECL are recognised as: lifetime ECL (ECL resulting from default events over the life of the instrument) for financial instruments if there has been a significant increase in credit risk since initial recognition and the resulting credit quality is not considered to be low credit risk (stages 2 and 3); and 12-month ECL (ECL resulting from default events within the next 12 months) for all other financial instruments (stage 1).

default events in order to build a model (such as those exposures of high credit quality). The consideration of forward-looking information was also described as a challenge under IFRS 9;

- **In terms of availability of resources**, the two main aspects mentioned are the limited availability of internal resources and finding enough resources with the right skills.

50. At the current stage of IFRS 9 implementation, the interpretation of the concept of ‘undue cost and effort’³¹ was less detailed in the responses, and respondents mentioned that it would be mainly based on cost–benefit considerations (i.e. how the cost—such as operational complexity, resources—of applying a particular approach compares to the related benefits or the materiality of the potential impact created by applying this approach).

EBA recommendation

As banks are in the process of developing aspects of their IFRS 9 methodologies, they should use all reasonable and supportable information relevant to the group or individual exposure as needed to achieve high-quality, robust and consistent implementation of IFRS 9. Nevertheless, the EBA acknowledges that additional cost and operational burden do not need to be introduced where they do not contribute to a high-quality implementation of IFRS 9.

Use of existing processes, systems, models and data

51. Banks are generally looking to leverage off (to the extent possible) the existing governance processes and quality controls used in the current prudential framework and/or internally for credit risk management.

52. Those banks that already use IRB approaches to some extent generally believe that existing processes, systems, models and data are likely to be in place and can be used—possibly after adjustment—for the purposes of IFRS 9 application. Banks that use the SA only may not have such capabilities in place.

53. Although it is too early to be certain about the impact of IFRS 9 on banks’ IRB methodologies, at this stage, these banks do not expect a major impact to IRB models and **do expect potential benefits from the use of the same models for regulatory and accounting purposes.**

54. **Many banks will amend their existing credit risk management practices in light of the application of IFRS 9**, particularly with regard to the need to strengthen the requirements for granting loans (underwriting standards), pricing, risk appetite and monitoring of credit

³¹ Under IFRS 9, paragraph B5.5.15, ‘an entity shall consider reasonable and supportable information that is available without undue cost and effort’ when estimating ECL.

risk, as well as to apply more robust governance and to include IFRS 9 data in risk management. These are considered consistent with sound credit risk management practices.

55. Some banks will build new models for IFRS 9, although these models will leverage off (to some extent) the existing regulatory and/or risk management models with adjustments made for differences between the objectives of, and inputs used for, IFRS 9 and for regulatory/risk management models.

- Respondents mentioned the following as the **main differences between IFRS 9 and prudential requirements for the estimation of ECL**: (i) applying a through-the-cycle estimation for prudential purposes as opposed to a point-in-time estimation under IFRS 9; (ii) applying a 12-month estimated PD for prudential purposes as opposed to a lifetime PD under IFRS 9 (for stages 2 and 3); and (iii) including prudential floors and downturn adjustments in the EAD and LGD estimations for prudential purposes, as opposed to performing a neutral estimate for both EAD and LGD under IFRS 9. However, it was not evident from the responses the extent to which the adjustments required to address these differences for implementing IFRS 9 could be challenging.
- Hence, **banks significantly leveraging off their existing systems are likely to make adjustments** to those existing models and, most commonly, for the PD, LGD and EAD (for instance, to eliminate the conservatism of the regulatory model or to generate multi-period parameters) together with the consideration of forward-looking information (including macroeconomic data) and different scenarios. For the projection of macroeconomic information, banks also plan to leverage off their stress test methodology and use their stress test information, presumably to the extent that those methodologies and information are suitable for IFRS 9 purposes.

56. Banks are currently defining the methodologies and models for the measurement of ECL and, therefore, for some banks, it is too early to provide details on the validation of their models and back-testing. However, it has to be noted that those banks that have elaborated on this issue have referred mostly to the application of a similar validation process as used for the regulatory models or for the existing credit risk models.

EBA recommendation

The possible synergies and also the impact of IFRS 9 on the IRB regulatory capital models should be considered. Banks can benefit from alignment of their prudential and accounting models, if the prudential models are fit for IFRS 9 purposes. This will allow the use of infrastructure already developed by the bank (such as methodologies, data and models) and allow for greater consistency within a bank (for example, in terms of the governance arrangements used).

Banks should also establish policies and procedures to appropriately validate the models used to measure ECL within an effective internal control system for credit risk assessment and measurement. Banks using existing validation processes (employed for other purposes) should

make any necessary adjustments to them in order to ensure that the validation process is suitable for the purposes of IFRS 9 implementation.

Banks should understand the links between IFRS 9 disclosure requirements and existing disclosure practices and regulatory requirements (for example, Pillar 3 disclosures) and highlight those links where possible in order to ensure consistency and improve efficiency.

Group and local methodologies

57. Most banks will develop and implement centralised group-wide IFRS 9 methodologies, which will mainly include the interpretation of aspects of IFRS 9, such as the indicators to be used for the assessment of a significant increase in credit risk, the models to be used for the measurement of ECL and the forward-looking information to be considered (including macroeconomic scenarios) by entities within a group. Banks will also take into consideration subsidiary-specific products/portfolios and local economic factors so that local specificities are considered.

EBA recommendation

Most banks intend to centralise the application of the IFRS 9 impairment requirements across group entities and to use similar policies, methodologies, scenarios and interpretations across the group. This will increase consistency in the application of IFRS 9 within a group. However, it is equally important that the group takes into consideration subsidiaries' local specificities (for instance, adjustments to the centralised scenarios to consider local economic conditions) at both the group and the entity levels. This will ensure that the estimation of the ECL reflects these specificities, rather than applying one-size-fits-all accounting practices within groups.

Methodology for ECL measurement

58. Approaches on ECL measurement vary across banks and depend on factors such as: the type of exposure (business line), materiality of the exposure, stage at which the exposure is classified under IFRS 9, whether a collective or individual assessment is performed, and classification in the SA or IRB portfolio. However, the methodologies are not yet finalised and were, therefore, often described in the responses in less specific terms. **As implementation of IFRS 9 approaches, the methodologies will become more specific.**

59. As a reminder, in accordance with IFRS 9 (paragraph 5.5.17-18), an entity shall measure ECL for a financial instrument in a way that reflects: (a) an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes; (b) the time value of money; and (c) reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions. When measuring ECL, an entity need not necessarily identify every possible scenario. However, it shall consider the risk or probability that a credit loss

occurs by reflecting the possibility that a credit loss occurs and the possibility that no credit loss occurs, even if the possibility of a credit loss occurring is very low.

60. In terms of specific aspects of the ECL methodology:

- **Almost all banks³² have referred to the use of a PDxLGDxEAD approach to measure ECL (at least for some portfolios)**, depending on the type of the exposure, materiality of the exposure, stage at which the exposure is classified under IFRS 9, collective or individual assessment, and the classification in the SA or IRB portfolio as previously mentioned.
- **Most banks expect that they may have to make additional adjustments (so called overlays) in their IFRS 9 models for the ECL estimation** mainly to reflect the impact of any information not fully reflected in the model, to incorporate some specifications of some portfolios that cannot be captured by the models, or to correct some model deficiencies.
- **Almost all banks intend to use the same definition of default for accounting and prudential purposes.**

61. **The most commonly mentioned criteria for grouping financial assets with similar credit risk characteristics by banks are the existing prudential segmentation criteria for IRB purposes**, together with consideration of product type (for instance, mortgage loans, consumer loans) and the rating or the PD of the exposure, followed by the counterparty type (for instance, SMEs, corporates, institutions), the loan-to-value (LTV) ratio, LGD and geographical location.

EBA recommendation

As many banks expect to make adjustments to their models for ECL measurement (for example, to reflect additional information not captured in the model), they should ensure a high-quality and robust implementation of IFRS 9 and that these adjustments are subject to an appropriate governance process.

The EBA has finalised guidelines on the definition of 'default'³³ and, as banks are aiming to use consistent definitions for accounting and prudential purposes, it is expected that banks will be guided by these guidelines when implementing IFRS 9.

Re-segmentation of portfolios and/or additional adjustments to ECL may be required to adequately reflect changes in facts and circumstances in ECL measurement. Hence, banks should

³² There were a few banks that did not provide information on the methodology for ECL measurement.

³³ <http://www.eba.europa.eu/regulation-and-policy/credit-risk/guidelines-on-the-application-of-the-definition-of-default>.

regularly question the appropriateness of the segmentation and assess whether re-segmentation is needed.

Specific input to ECL measurement

62. Internal information will be the most important source to estimate ECL. This may come from internal data systems and/or information already used in IRB models or in other exercises (for instance, stress test). External data (such as rating agencies) will also be relevant, particularly when internal information is not available (for example, for low default rate portfolios such as sovereign exposures) or for macroeconomic information.

63. IFRS 9 requires that the measurement of ECL reflects an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes (IFRS 9 5.5.17). Most banks intend to use multiple forward-looking scenarios. However, this is an area for which only some banks provided an answer (29% of the banks in the sample) and on which banks are currently still reflecting (for instance, how many scenarios to use, what type of scenarios to use), particularly in light of the relevant discussion by the IFRS Transition Resource Group for Impairment of Financial Instruments (ITG) during which it was clarified that banks should consider multiple scenarios (although this does not mean that all of them need to be used in the measurement of ECL).³⁴

64. The majority of banks will use a combination of qualitative and quantitative indicators to assess whether a significant increase of credit risk has occurred. The indicators used will depend mainly on the asset class, with differences being mainly between retail (credit scoring and days past due used), wholesale (rating and watch lists used) and sovereign exposures (market information and more expert judgement used). In particular:

- **Quantitative indicators** – Banks will mostly consider the change in the PD as a primary quantitative indicator of significant increase in credit risk or the rating migration of an exposure. The past due status of exposures will also be considered, but mainly as a backstop for assessing the significant increase of credit risk.
- **Qualitative indicators** – Banks will mostly consider the use of watch-list status/monitoring, restructuring/forbearance measures and forward-looking (macroeconomic) information.

EBA recommendation

In terms of the use of the appropriate range of forward-looking information, the EBA highlights that the IASB and its ITG have discussed several implementation issues related to IFRS 9 impairment requirements. One of those discussions was related to the use of multiple scenarios to incorporate forward-looking information. The discussion clarified that, while entities are not

³⁴ <http://www.ifrs.org/About-us/IASB/Advisory-bodies/ITG-Impairment-Financial-Instrument/Pages/Meetings.aspx>.

expected to consider every possible scenario, the scenarios considered should reflect a representative sample of possible outcomes.

Practical expedients/simplifications

- **Low credit risk exemption³⁵ – Almost half of the banks are considering the application of the low credit risk exemption.** The factors most commonly being considered in order to apply the exemption are the type of exposure (mainly debt securities), the credit risk of the exposure (mainly investment grade exposures) and the counterparty (governments, central banks and banks). In general, banks do not plan to apply this exemption to retail loans.
- **The 30 days past due criterion³⁶ – Most banks are considering applying this criterion for classifying an exposure from stage 1 to stage 2, although it will not be used as a primary indicator of a significant increase in credit risk.** Instead, it will be used together with other credit risk indicators as a backstop. This is also consistent with the draft EBA guidelines on ECL under which the use of the simplification as a backstop is not precluded alongside other, earlier indicators for assessing significant increase in credit risk. In some cases, banks are considering using this simplification for insignificant parts of their portfolio or where sufficient information is not available.
- **The 12-month PD as a proxy for changes in the lifetime PD³⁷ – Most banks are considering the possibility of applying this simplification and, in doing so, are evaluating whether there is a high correlation between the 12-month PD and the lifetime PD** (meaning that the 12-month PD is a good proxy for changes in the lifetime PD). It may also be that banks decide to only apply this proxy to certain portfolios.
- **Significant increase in credit risk by comparing it to the maximum initial credit risk³⁸ – The fewest number of banks plan to use this simplification/practical expedient**

³⁵ An entity may 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—i.e. when the financial instrument has a low risk of default—as the borrower has a strong capacity to meet its contractual cash flow obligations in the near term and adverse changes in economic and business conditions in the longer term may, but will not necessarily, reduce the ability of the borrower to fulfil its contractual cash flow obligations (IFRS 9 5.5.10 and B5.5.22–B5.5.24).

³⁶ When information that is more forward-looking than past due status (either on an individual or a collective basis) is not available without undue cost or effort, an entity may use past due information to determine whether there have been significant increases in credit risk since initial recognition. Regardless of the way in which an entity assesses significant increases in credit risk, there is a rebuttable presumption that the credit risk on a financial asset has increased significantly since initial recognition when contractual payments are more than 30 days past due (IFRS 9 5.5.11 and B5.5.19–21).

³⁷ Changes in the risk of a default occurring over the next 12 months may be a reasonable approximation of the changes in the lifetime risk of a default occurring (IFRS 9 B5.5.13).

³⁸ The IASB noted that the assessment of significant increases in credit risk could be implemented more simply by determining the maximum initial credit risk accepted by the reporting entity for a particular portfolio of financial instruments and then comparing the credit risk of financial instruments in that portfolio at the reporting date to that

(compared to other possible IFRS 9 simplifications). These banks plan to use it only for specific portfolios/types of exposures (for instance, retail or investment grade securities).

EBA recommendation

Available practical expedients (simplifications) of IFRS 9 will be used by banks. Some of these may be used more than others (also depending on the type of portfolio). In addition, most banks will use the 30 days past due criterion, although not usually as a primary indicator of significant increase in credit risk. If the use of practical expedients creates bias in the estimation of ECL—which, for example, is what using a 30 days past due test to identify significant increases in credit risk can do—credit institutions should consider the need to make adjustments to counter that bias and that these adjustments are subject to appropriate governance processes in order to ensure that the objectives of IFRS 9 are met.

Other qualitative impacts – Implications for supervisors

Impact on volatility

65. Most banks (62%) do not anticipate a significant impact on volatility on an ongoing basis from the relevant changes in the classification and measurement of financial instruments under IFRS 9 compared to IAS 39, as the relevant changes due to IFRS 9 are generally limited. However, some banks expect higher volatility in profit or loss due to the reclassification of some instruments (such as equity instruments and investments in funds, loans or debt securities with more complex features) to FVPL under IFRS 9.

66. 75% of the banks included in the survey anticipate that IFRS 9 impairment requirements will increase volatility in profit or loss. Respondents mentioned that this was mainly due to the ‘cliff-effect’ when ECL increases from stage 1 to stage 2 (12-month ECL to lifetime ECL) to reflect a significant increase in credit risk due to the movement between stages 1 and 2 and due to the inclusion of forward-looking information in the ECL estimation (that will need to be re-assessed at each reporting period). However, 16% of the banks do not anticipate that the IFRS 9 impairment requirements will significantly increase the volatility in profit or loss compared to IAS 39, as the ECL model under IFRS 9 may lead to a more gradual recognition of losses compared to the level of losses recognised under IAS 39 (which is based on an incurred loss model). Other banks (9%) are not able to assess the impact at the current stage.

maximum initial credit risk. However, this would only be possible for portfolios of financial instruments with similar credit risk at initial recognition (BC5.161 and illustrative example 6 of IFRS 9).

EBA recommendation

The assessment of the possible volatility introduced by IFRS 9 is an aspect that needs to be monitored. Significant volatility seems unlikely to arise from the new IFRS 9 classification and measurement requirements because the amount of assets that will be reclassified from amortised cost to FVPL or FVOCI seems unlikely to be large. On the other hand, volatility could arise in profit or loss from the new impairment requirements when forecasted economic conditions change, together with the increase in loss allowance when financial instruments move between 12-month and lifetime ECLs and vice versa. However, it should be acknowledged that IFRS 9 should result in an earlier recognition of losses compared to IAS 39.

Impact on lending practices

67. Most banks do not anticipate an impact on the types, duration or the collateralisation of products offered in the market due to the changes in the classification and measurement criteria under IFRS 9. For those banks that anticipate an impact, the changes they see as most likely are changes to the contractual characteristics of some instruments so that they can pass the SPPI assessment (and do not need to be classified at FVPL).

68. 60% of the banks anticipate that IFRS 9 impairment requirements will have an impact on lending practices of banks in terms of the pricing of products, the maturity of the products and underwriting practices. However, a significant number of banks (28%) do not expect an impact on lending practices due to IFRS 9, as the main elements of IFRS 9 are already embedded in the pricing of products and risk management.

EBA recommendation

The impact of the introduction of IFRS 9 on the types and duration of products offered in the market is an aspect that should be considered after the implementation of IFRS 9.

Quantitative assessment

Total impact on capital requirements from IFRS 9

69. The total impact on capital requirements is mainly driven by the impairment requirements and, to a lesser extent, by the classification and measurement requirements of IFRS 9.

70. In terms of the estimation of the total quantitative impact of IFRS 9, the CET1 ratio is estimated to decrease, on average, by 59 bps and by up to 75 bps for 79% (75th percentile) of respondents.³⁹

³⁹ Averages indicate an approximation of the estimated possible impact, which should be considered together with the other quantitative metrics provided in this report.

71. **Total capital ratio is estimated to decrease, on average, by 45 bps and by up to 75 bps for 79% (75th percentile) of respondents.** Other metrics (median⁴⁰ and weighted average) used for the analysis have been included in the table at the end of part 2 of this report. This table includes a summary of the estimated quantitative impact of IFRS 9 for the sample and information on the assumptions used to calculate averages.

72. However, as is the case when using statistical metrics, it should be noted that some of the estimates related to the total sample of respondents were different from the above-mentioned estimates.

Classification and measurement

Balance sheet – Measurement basis under IAS 39 and IFRS 9

73. In terms of types of financial assets, most banks' balance sheets consist mainly of loans and advances and debt securities (on average, 73% of the financial assets are classified as loans and advances, 17% as debt securities, 8% as derivatives and 2% as equity instruments). A significant part of debt securities are the debt securities of general governments. With regard to the measurement methods, on average, balance sheets for 74% of banks (mainly loans and receivables) are currently measured at amortised cost, 16% at FVPL and 10% at FVOCI.

74. Under IFRS 9, banks responding to the survey estimated that:

- **Debt securities are likely to continue being measured at fair value.** In this regard, the FVOCI would be the most relevant category (53% for the average⁴¹ and up to 69% of total debt securities for the 75th percentile). However, in limited cases, debt securities may be reclassified mainly from FVOCI under IAS 39 to amortised cost under IFRS 9.
- **In some cases, equity instruments are likely to change measurement basis, moving mainly from FVOCI under IAS 39 to FVPL under IFRS 9.** However, given the lower materiality of these exposures (2% for the average⁴² and up to 2% of total financial assets for the 75th percentile of respondents), the overall impact on the measurement basis of total financial instruments for each bank is unlikely to be significant. The quantitative estimate is consistent with the qualitative information provided by banks, in which limited reclassifications are mentioned by banks and which include equity instruments reclassified from FVOCI to FVPL under IFRS 9.
- **The vast majority of loans and advances are likely to continue being measured at amortised cost** and those that are currently being measured at FVPL are likely to continue

⁴⁰ 50th percentile.

⁴¹ 55% for the median.

⁴² 1% for the median.

to be measured on that basis under IFRS 9. However, in limited cases, loans and advances may be reclassified from amortised cost to fair value and vice versa.

Estimated impact on capital requirements from IFRS 9 classification and measurement

75. CET1 and total capital ratios are estimated to decrease by up to 25 bps for 88% (75th percentile) of the banks providing quantitative information on the impact of the application of the IFRS 9 classification and measurement requirements.⁴³

76. Overall, this quantitative estimation of the impact of the IFRS 9 classification and measurements is consistent with the view of the vast majority of respondents that there will be only limited differences in the classification between IAS 39 and IFRS 9. In some limited cases, there could be reclassifications of equity instruments (from FVOCI under IAS 39 to FVPL under IFRS 9) and for debt securities (from mainly FVOCI under IAS 39 to amortised cost under IFRS 9). In most cases, these instruments are less significant when compared to the total financial assets of the banks in the sample.

Impairment

77. In estimating the impact of IFRS 9 impairment requirements, institutions were to employ their best endeavours to use reasonable and supportable forward-looking information available at the time of completing these templates in order to estimate ECL.

78. Banks made several assumptions and simplifications in providing quantitative estimates, mainly by: making a limited use of forward-looking information in providing estimates (for example, the use of a single macroeconomic scenario), estimating the impact for a sample of the portfolio and extrapolating the results to the whole population of exposures, conservative assumptions (for example, the allocation of an increase of provisions to stage 2 only in the absence of available detailed information), and using proxies when point-in-time estimates for the PD, EAD and LGD were not available. Having said that, some of the assumptions and simplifications used by some respondents would influence the accuracy of the impact of IFRS 9; some respondents used an overlay to compensate for this, while others did not.

Exposures with IAS 39 provisions

79. IAS 39 provisions derive mainly from loans and advances, with the main counterparties being households and non-financial corporations.

⁴³ Other metrics (median) used for the analysis have been included in the table at the end of part 2 of the report.

Estimated increase of provisions under IFRS 9

80. Under IFRS 9, the estimated increase of provisions for on-balance-sheet and off-balance-sheet exposures compared to the current levels of provisions under IAS 39 is, on average, up to 18% and up to 30% for 86% (75th percentile) of respondents.⁴⁴

81. The estimated change in provisions varies from portfolio to portfolio—and, therefore, across entities—depending on, for example, the type of exposure, the counterparty, the size of the bank and/or the current level of provisions under IAS 39. The estimated increase of provisions **is mainly the result of stage 2 provisions** for loans and advances to households followed by stage 2 provisions for loans and advances to non-financial corporations.

82. Regarding the estimated increase of provisions for debt securities, the estimated increase is more than 400%⁴⁵ for the 75th percentile of respondents. However, it should be mentioned that, for the vast majority of the respondents, the current IAS 39 provisions for debt securities is lower (or even null) compared to the IAS 39 provisions for loans and advances (as a result of the different credit quality of the counterparties). The respondents allocated the estimated loss allowances for these exposures under IFRS 9 mainly in stages 1 and 2 (instead of stage 3, in which credit-impaired exposures are included). Therefore, it may be that a response of a 400% increase in provisions does not indicate that the total amount of provisions will be very high as an absolute number but just that the starting point was zero or a very low number.

83. It also needs to be borne in mind that not all respondents provided quantitative data on the impact in order to be able to understand, in more detail, the drivers of the increases in provisions under IFRS 9 related to the types of exposures and counterparties affected.

Estimated impact on capital requirements from IFRS 9 impairment

84. In terms of the estimation of the quantitative impact of the impairment requirements of IFRS 9, CET1 ratio is estimated to decrease by up to 75 bps for 85% (75th percentile) of respondents. Total capital ratio is estimated to decrease by up to 50 bps for 75% (75th percentile) of respondents.⁴⁶ The impact on total capital ratio is lower compared to the impact on CET1 ratio because the excess of accounting provisions for IRB portfolios over regulatory expected losses is added back to Tier 2, subject to a regulatory cap.

⁴⁴ Other metrics (median and weighted average) used for the analysis have been included in the table at the end of part 2 of the report. This table includes a summary of the estimated quantitative impact of IFRS 9 for the sample and information on the assumptions used to calculate averages.

⁴⁵ It should be noted that respondents were asked to provide this information in ranges and the upper range response provided in the template was an increase in provisions of more than 400%. For instance, if the starting point was zero provisions, it may be that any increase in provisions would have been classified as more than 400% (as any increase will be infinite).

⁴⁶ Other metrics (median) used for the analysis have been included in the table at the end of part 2 of the report.

SA and IRB banks

85. The increase of provisions under IFRS 9 and the allocation to stages 1, 2 and 3 will most likely be evenly allocated between SA and IRB exposures. **Banks mainly using the SA for measuring credit risk tend to have a higher estimated impact on own funds from the IFRS 9 impairment requirements compared to the estimated impact for banks mainly using the IRB approach due to the current prudential treatment of provisions.** According to this treatment, the shortfall of accounting provisions over regulatory expected losses under the IRB approach will absorb or partially absorb the impact of IFRS 9 on own funds, which is not the case under SA.

Smaller and larger banks

86. **Smaller banks have estimated an increase of provisions of up to 30%—which is within the range of estimation for the 86% of respondents—and, therefore, the estimated increases of provisions above that percentage are performed by a few larger banks of the sample.** However, the higher estimated increases of accounting provisions for these larger banks did not lead (in all cases) to a higher impact on own funds compared to the impact on own funds for banks with lower estimated increases of provisions. This may be explained by the fact that those larger banks have more exposures under the IRB approach and, therefore, do not suffer a decrease in own funds until the accounting provisions have risen above the regulatory expected losses. In this case, these banks indeed have a capital shortfall under IAS 39, which can ‘absorb’ the impact from the increase of provisions under IFRS 9.

Summary of IFRS 9 quantitative estimations

Estimated increase of provisions IFRS 9			
<i>in %</i>			
Median¹		20%	
Average			
Mid of estimated range ²		18%	
Weighted Average³			
Conservative estimation in range ⁴		26%	
Mid of estimated range		21%	
75th percentile¹		30%	
% of respondents below or at the data point of the 75 th percentile		86%	
Estimated impact on CET1 ratio IFRS 9			
<i>In bps</i>			
	Total impact of IFRS 9	Classification and measurement	Impairment
Median	-50	-25	-50
Average			
Mid of estimated range	-59		
Weighted Average			
Conservative estimation in range	-55		
Mid of estimated range	-42		
75th percentile	-75	-25	-75
% of respondents below or at the data point of the 75 th percentile	79%	88%	85%
Estimated impact on total capital ratio IFRS 9			
<i>In bps</i>			
	Total impact of IFRS 9	Classification and measurement	Impairment
Median	-25	-25	-25
Average			
Mid of estimated range	-45		
Weighted Average			
Conservative estimation in range	-43		
Mid of estimated range	-30		
75th percentile	-75	-25	-50
% of respondents below or at the data point of the 75 th percentile	79%	88%	75%
¹ The median and the 75 th percentile refer to the upper limit of a range selected from the survey. ² Mid of estimated range is the value between the lowest and highest values within a bank's estimated range of impact. ³ Weighted average is calculated on the basis of the % of the total assets under IAS 39 of each bank to the sample. ⁴ Conservative estimation is the highest value within a bank's estimated range of impact.			

3. Areas of further work – The way forward

87. The EBA believes that certain aspects related to the implementation of IFRS 9 by banks, particularly in terms of interaction with prudential requirements, should be developed further. This part of the report includes the intended work of the EBA in this field.

a. The EBA's second exercise

88. The EBA is launching a second exercise that is designed on the basis of the outcome of the first exercise in order to better understand some specific areas following the analysis of the information collected in the first exercise. Banks are also expected to have further developed their methodologies towards the implementation of IFRS 9 and, therefore, should be able to provide more up-to-date information on the possible impacts of IFRS 9 and its interaction with prudential requirements.

b. Supervisory actions – Implementation issues

89. Competent authorities may discuss the individual results or implementation projects of IFRS 9 with banks.

90. The EBA will follow up on the results of this first exercise for the EU banking sector and continue the discussion with banks and auditors on those issues where the exercise indicated that there could be different levels of implementation.

c. Prudential actions – Interaction with IFRS 9

Guidelines on credit risk management practices and accounting for ECL

91. The exercise highlighted areas that require judgement to be applied by banks (for example, the assessment of a significant increase of credit risk), as well as areas that might impose significant challenges to banks (for example, the use of forward-looking information and the availability of data). Banks are still developing their processes, systems, models, data and methodologies for implementing IFRS 9 and, in this process, the EBA guidelines on ECL (particularly in their final form) will provide guidance to banks for the robust implementation of IFRS 9.

Guidelines on communication between competent authorities and auditors⁴⁷

92. The replacement of IAS 39 with IFRS 9 is a subject that is likely to be covered in the communications between the competent authorities and auditors under the recently published EBA guidelines on the communication between the two parties. Indeed, this is a change in the accounting standards that merits additional consideration for inclusion in the communications. In addition, the auditors are likely to be involved in the preparation of the implementation of IFRS 9 for one or more banks, and they should be well placed to share relevant information with the competent authority and discuss IFRS 9 implementation issues in accordance with the application of these guidelines.

RTS on SCRA and GCRAs⁴⁸

93. For institutions applying the SA for measuring capital requirements for credit risk, CRAs⁴⁹ can be considered general or specific. The criteria to differentiate between SCRA and GCRAs under the applicable accounting framework are currently established in the RTS for specifying the calculation of SCRA and GCRAs (RTS on SCRA and GCRAs). While both specific and general CRAs impact CET1 capital, the difference is that GCRAs do not reduce the exposure value and are included in Tier 2 up to 1.25% of the bank's credit risk RWAs, whereas SCRA reduce the exposure value and are not added back to any part of the regulatory capital.

94. In Recital 9 of the RTS on SCRA and GCRAs, it is mentioned that the criteria for distinguishing between SCRA and GCRAs should be established taking into account current applicable frameworks. In Recital 10 of the same RTS, it is mentioned that, in the event of the revision of the accounting standards, changes to the criteria for distinguishing between SCRA and GCRAs may be necessary, particularly for the new impairment model of IFRS 9. At the EU level under IAS 39 or national GAAP, loan loss provisions should normally be classified as SCRA.

95. On 11 October 2016, the BCBS published a consultative document⁵⁰ that proposes an interim period to retain the current regulatory treatment of provisions as applied under both the SA and the IRB approach. According to the document, jurisdictions would then need to extend their existing approaches to categorising provisions as specific or general to provisions measured under the applicable ECL model. In addition, the document

⁴⁷ EBA/GL/2016/05 (<https://www.eba.europa.eu/regulation-and-policy/accounting-and-auditing/guidelines-on-communication-between-competent-authorities-and-auditors>).

⁴⁸ Commission Delegated Regulation (EU) No 183/2014 of 20 December 2013 supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms, with regard to the RTS for specifying the calculation of SCRA and GCRAs (text with EEA relevance).

⁴⁹ According to the CRR, 'CRA means the amount of specific and general loan loss provisions for credit risks that have been recognised in the financial statements of the institution in accordance with the applicable accounting framework.

⁵⁰ <https://www.bis.org/press/p161011.htm>.

encourages regulators to provide guidance, as appropriate, on categorising ECL provisions as general and specific provisions in their jurisdictions.

96. Therefore, the mapping of IFRS 9 provisions as GCRA or SCRA merits additional assessment, as the RTS on CRA was developed when IAS 39 was applied. In this regard, it could be considered whether—as is the general case today under IAS 39—all IFRS 9 loan loss provisions should be considered SCRA or whether different options should be explored for the application of the definition of GCRA and SCRA in the context of the IFRS 9 ECL framework.

97. The EBA will work during the next months in assessing this issue and performing further outreach activities in order to consider the most appropriate course of action, also taking into account the timeline for the implementation of IFRS 9.

Current and future treatment of accounting provisions in own funds

98. As the current regulatory framework was developed when an incurred losses accounting model was mainly applied, the introduction of the ECL model for provisioning warrants an assessment of the interaction of the new provisioning model with the prudential framework to ensure a level playing field across institutions using national GAAP and IFRS.

99. The BCBS has published a discussion paper on 11 October 2016⁵¹ that acknowledges this and proposes the following long-term approaches for comments: (i) to retain the current regulatory treatment of provisions (i.e. discretion at jurisdiction level to decide on the classification of provisions as specific or general); (ii) to retain the distinction between specific and general provisions for regulatory purposes based on definitions that would produce universally aligned categorisations of ECL provisions as specific and general across jurisdictions; (iii) to introduce a standardised regulatory expected loss component to the SA for credit risk; or (iv) pursue another alternative based on the comments received on the discussion paper.

100. These are complex issues that will require a discussion in the medium term. The EBA is participating in the discussions at the BCBS level and will continue assessing these issues.

Transitional arrangements

101. One aspect to consider is whether transitional arrangements should be introduced to lessen the impact of IFRS 9 on capital. This possibility has been raised in the recently published BCBS consultative document. According to this document, the BCBS has identified some reasons why it may be appropriate to introduce a transitional arrangement

⁵¹ The BCBS has published, at the same time, a consultative document on the regulatory treatment of accounting provisions (interim approach and transitional arrangements) and a discussion paper on the regulatory treatment of accounting provisions.

for the impact of ECL accounting on regulatory capital in order to allow banks time to adjust to the impact that the new ECL accounting standards will have on capital for regulatory purposes. The BCBS has not yet determined whether or not the introduction of a transitional arrangement is warranted and is seeking comments on the options proposed in its consultative document.

102. On the basis of the results of the first exercise, the EBA has not yet formed a view on a possible transition and believes that the results of the second exercise should help in forming a final view on a possible transitional arrangement.

103. In case a transitional arrangement appears to be needed, the following aspects would probably need to be considered:

- The approach should be as simple as possible;
- The period of application of the transitional requirements may depend on the magnitude and type of the impact. However, in principle, a short transitional period would be preferable;
- Proposals that would result in a complete neutralisation of the impact from the move to an ECL model and the corresponding impact on own funds of some provisions during the transitional period should not be pursued. In the same vein, proposals that would lead to a complete prudential neutralisation of stage 1 provisions for a certain period of time should be regarded with scepticism, as this may give wrong incentives to banks for moving exposures from stage 1 to stages 2 and 3 as appropriate.

104. The EBA will continue its reflection, particularly in light of the outcome of the second impact assessment exercise, and will work on the technical aspects of a possible transitional arrangement in case such a transition would be introduced.

Other interactions of prudential requirements with IFRS 9

105. This exercise did not indicate any other significant interaction of prudential requirements with IFRS 9 (for example, liquidity, prudent valuation or leverage requirements). However, some aspects mentioned by a few banks were the EBA guidelines on the definition of 'default', the classification under IFRS 9 of the liquidity portfolio or bail-in instruments, the possible deterioration of the leverage ratio (because the CET1 reduction of the numerator is only compensated to a small fraction by the reduction of the exposure measure in the denominator). The EBA will be monitoring the possible occurrence of additional interactions towards the initial implementation of IFRS 9 and beyond that in order to identify any emerging interaction, as more knowledge and experience will have been obtained at that time.

106. In accordance with Article 80 of the CRR, the EBA will advise the European Commission as far as necessary on any changes that it deems necessary to the definition of ‘own funds’, particularly as a result of changes stemming from IFRS 9. In all cases, there are several technical issues to be investigated and that may not be feasible to solve in a quick manner due to the fact that progress in the analysis will be linked to progress in the implementation of IFRS 9. The EBA will stay in close contact with institutions, competent authorities and other stakeholders such as auditors to discuss the various aspects linked to the implementation of IFRS 9.