



EBA REPORT ON RESULTS FROM THE SECOND EBA IMPACT ASSESSMENT OF IFRS 9

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EBA

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Abbreviations

bps	basis points
BCBS	Basel Committee on Banking Supervision
CCF	credit conversion factor
CET1	Common Equity Tier 1
EAD	exposure at default
EBA	European Banking Authority
ECL	expected credit losses
EEA	European Economic Area
EFRAG	European Financial Reporting Advisory Group
EL	expected loss
EU	European Union
FVO	fair value option
FVOCI	fair value through other comprehensive income
FVPL	fair value through profit or loss
G-SII	global systemically important institution
IASB	International Accounting Standards Board
IAS 39	International Accounting Standard 39 — Financial Instruments: Recognition and Measurement
ICAAP	Internal Capital Adequacy Assessment Process
IFRS 9	International Financial Reporting Standard 9 — Financial Instruments
ITG	IFRS Transition Resource Group for Impairment of Financial Instruments
IRB	internal ratings-based
ITS	Implementing Technical Standards
LGD	loss given default
MREL	minimum requirements for eligible liabilities
NPE	non-performing exposure
OCI	other comprehensive income
O-SII	other systemically important institution
PD	probability of default
RTS	Regulatory Technical Standards
RWA	risk-weighted asset
SA	standardised approach
SPPI	solely payment of principal and interest

Executive summary

Following the publication of the report on the first European Banking Authority (EBA) exercise¹, in the context of the forthcoming implementation of IFRS 9 in the European Union (EU), the EBA launched, in November 2016, the second stage of the exercise² to obtain more data on some specific areas as banks further develop their methodologies for the implementation of IFRS 9. This report is an own-initiative project from the EBA³.

The second EBA exercise is more focused and builds on the objectives of the first exercise, namely gaining a better understanding of the stage of preparation for the implementation of the Standard, the estimated impact of IFRS 9 on regulatory own funds, the interaction between IFRS 9 and other prudential requirements, and implementation issues relating to IFRS 9. The sample was similar to that in the first exercise, consisting of approximately 50 institutions across the European Economic Area (EEA).

As institutions have made further progress in developing the necessary processes, models and capabilities for the implementation of IFRS 9, the quality of information provided in the current exercise has improved compared to the first exercise: there is more certainty as to the implementation approaches that will be adopted³, and the assessments of day-one impact are generally more reliable.

Content of the report

Part 1 ('Introduction') of the report includes background information on this exercise, including 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, and includes recommendations relevant to some of these observations⁴. 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 (February 2017) — which was based on banks' estimations as of 31 December 2016 or in fewer instances as of 30 September 2016 — most banks were in the building phase of preparation for the implementation of IFRS 9.

As banks still need to finalise their processes, systems, models and data, the quality of the information provided in this exercise is expected to be further improved as banks get closer to the application of IFRS 9. When providing this information, banks have made some assumptions and

¹ <https://www.eba.europa.eu/-/eba-provides-its-views-on-the-implementation-of-ifrs-9-and-its-impact-on-banks-across-the-eu>

² <https://www.eba.europa.eu/-/eba-launches-second-impact-assessment-of-ifrs-9-on-eu-banks>

³ It is also included in the EBA's work programme: <http://www.eba.europa.eu/about-us/work-programme/current-work-programme>.

⁴ The recommendations provided in the report are not meant to be exhaustive.

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

That said, the EBA will closely monitor the implementation of IFRS 9 by EU banks and undertake additional steps as necessary to address issues that are relevant to prudential regulators.

1. Main observations of the impact assessment exercise

Being a more focused exercise, the second exercise confirmed several observations of the first exercise but also highlighted some additional ones. In particular, some of the main additional issues that were highlighted in this exercise are the following:

- At a high level, implementation efforts have progressed (development of processes, systems, models and data), but some more complex elements of IFRS 9 still need to be addressed.
- The second exercise confirmed that the estimated quantitative impacts of IFRS 9 on Common Equity Tier 1 (CET1) ratio and total capital ratio follows the trend identified during the first exercise, with no further negative impact on the regulatory ratios, and it is estimated that they will be limited overall. In the second exercise, the average estimated impact of IFRS 9 on CET1 ratio is a 45 basis points (bps) decrease, and its average estimated impact on the total capital ratio is a 35 bps decrease⁵.
- This exercise provides more insight than the first, both qualitatively and quantitatively, regarding the impact of IFRS 9 on smaller banks⁶, which mainly use the standardised approach (SA). The vast majority of the banks in the sample provided all the requested qualitative and quantitative information on the estimated impact of IFRS 9.
- Smaller banks (which tend to use the SA for measuring credit risk) estimated a larger impact on own funds ratios due to IFRS 9 than larger banks (which tend to use the internal ratings-based (IRB) approach). However, smaller banks have estimated a lower increase in provisions due to IFRS 9 than larger banks.
- Of particular concern to the EBA are the reduced parallel runs of IFRS 9 and IAS 39, and in some cases the absence of parallel runs, which was mentioned by a significant number of the banks in the sample (19%). The EBA encourages banks to carry out intensive testing of their IFRS 9 processes and approaches, particularly those relating to the implementation

⁵ Respondents estimated the impact of IFRS 9 on own funds without consideration of any possible transitional arrangements.

⁶ For the purpose of this analysis, it is assumed that banks with total financial assets below EUR 100 billion are smaller banks compared with the rest of the sample.

of the impairment requirements, and to consider other means if necessary to ensure the quality of implementation of IFRS 9.

- In general, once IFRS 9 is applied, disclosures will be key, as stakeholders should have sufficient information to understand and evaluate the impact of the application of IFRS 9. Banks should be able to understand the behaviour of IFRS 9 numbers (and the differences compared with IAS 39) and provide useful information to internal and external stakeholders. In this regard, on initial application of IFRS 9, adequate disclosures about the impact of IFRS 9 on financial statements and regulatory capital will be particularly useful.
- The second exercise also highlighted that banks will use various processes, data, systems and models to estimate expected credit losses (ECL), which may be complex and require the use of internally generated data and assumptions. Following the implementation of IFRS 9, the EBA is particularly interested in achieving a better understanding of how the differences in the factors mentioned above may affect the measurement of ECL.
- In some cases, when processes, data, systems and models are not available, banks will use simplifications, proxies and tactical solutions to estimate ECL. The EBA believes that it is important that banks apply a sound and consistent methodology and governance process when making use of approximations to meet the objectives of IFRS 9 and to avoid bias in ECL measurement. Banks should also ensure on an ongoing basis that the use of approximations remains appropriate, in particular if circumstances change, which may necessitate a change in the use of such approximations.
- This exercise highlighted that many banks have yet to decide on the validation processes for ECL measurement. The EBA believes that it is of great importance that a robust validation process is implemented and that regular monitoring of the key elements of the ECL models is performed, to ensure the high-quality application of IFRS 9. In addition, it is important that banks ensure a robust governance framework of processes and controls around the IFRS 9 implementation on an ongoing basis.
- While noting that, by the time of the initial application of IFRS 9, banks should have completed the development of their methodologies to ensure the high-quality implementation of IFRS 9, the EBA also acknowledges that banks will continue improving elements of the implementation of IFRS 9 after its initial application.

Additional qualitative and quantitative observations and some EBA recommendations highlighted from this exercise are outlined, in more detail, in the following subsections.

1.1 Qualitative aspects

- Most banks in the sample are in the building or testing phase of implementation of the classification and measurement and the impairment requirements of IFRS 9, but the EBA is concerned that some banks are not sufficiently advanced in the implementation of IFRS 9.

The smaller banks in the sample have made progress on the implementation of IFRS 9 since the previous EBA exercise, but they are still lagging behind in their preparation compared with larger banks in the sample.

- The EBA welcomes the increase in the involvement of key stakeholders in IFRS 9 implementation. However, the EBA is concerned that in some cases key stakeholders such as the board of directors and the audit committees have not been sufficiently involved, which may lead to insufficient allocation of resources to the implementation of IFRS 9 and insufficient focus by the banks, as well as more challenges for these stakeholders in exercising their duties effectively, particularly during the transition to IFRS 9 and thereafter.
- Data quality, availability of historical data and the assessment of 'significant increase in credit risk', as required under IFRS 9, are the most significant challenges for banks responding to the survey, and they expect to make some simplifications⁷ in the absence of available data. It is important, however, that banks apply a sound and consistent methodology and governance process when making simplifications.
- The EBA reiterates its view that banks are likely to benefit from leveraging off their prudential models if, once appropriately adapted, those models are fit for IFRS 9 purposes. Banks should also be able to understand the reasons for the adjustments to be made to the regulatory data, processes and/or models, and justify the reasons for developing new models when they are not leveraging off their existing capabilities.
- To a large degree, banks expect to use internally generated data, assumptions and models for developing forward-looking scenarios with macroeconomic data. Scenarios should be appropriate and include the key risk drivers that are relevant to the exposure or portfolio of exposures. Consistency across the key risk drivers used to develop different scenarios within a bank is important.
- Banks will use various indicators for assessing significant increase in credit risk, together with IFRS 9 practical expedients and expert judgement. Sound governance, systems and controls will be necessary in assessing significant increase in credit risk.
- Overall, it is estimated that the impact of the change in classification and measurement requirements will be limited for most banks, as was the case in the first exercise. However, the operationalisation of the classification and measurement requirements will also require resources, and banks should not underestimate the challenges of implementing those requirements.
- As in the previous exercise, 72% of the banks included in the survey anticipate that IFRS 9 impairment requirements will increase volatility in profit or loss. Respondents mentioned

⁷ Simplifications may be needed, for example to determine the original credit risk of exposures that originated a long time ago or to build a model for high credit quality exposures where there is limited data on default events.

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), and to the inclusion of forward-looking information, which will need to be reassessed at each reporting period, in the ECL estimation. However, 28% of the banks do not anticipate that the IFRS 9 impairment requirements will significantly increase volatility in profit or loss compared with IAS 39, as the ECL model under IFRS 9 may lead to more gradual recognition of losses compared with the level of losses recognised under IAS 39 (which was based on an incurred loss model).

- The responses received suggest that IFRS 9 may have an impact on the lending practices of banks. However, banks were not able to provide more detailed estimates of the extent of this impact. In relation to long-term investments in equity instruments, which may also be considered a means of financing the economy, it has been observed that equity instruments represent a minor part of the banks' balance sheets. Having said that, the EBA understands that these are aspects that merit assessment in the longer term by all interested parties.

1.2 Quantitative aspects

Respondents provided estimates of the quantitative impact of IFRS 9 on selected financial and regulatory capital metrics at the time the exercise was conducted. In limited instances, respondents were asked for estimates in the form of an estimated range (rather than an absolute amount) of impact.

Quantitative estimates should be considered taking into account the limitations at the time of conducting this exercise, as mentioned above.

On this basis, the following aspects were observed:

- **The estimated quantitative impact⁸ of IFRS 9 on CET1 ratio and total capital ratio in the second exercise follows the trend identified during the first exercise, with no significant deviations in the estimations of the vast majority of banks or further negative impact on the regulatory ratios, and it is estimated that the impact will be limited overall. It is to be noted that the estimated increase in the level of provisions due to IFRS 9 is overall lower than in the first exercise.**
- It is estimated that the CET1 ratio will decrease, on average⁹, by 45 bps (59 bps decrease in the first exercise), and by up¹⁰ to 75 bps for 86% of respondents (75 bps decrease in the first exercise for 79% of respondents), due to the impact of the requirements of IFRS 9.

⁸ Respondents estimated the impact of IFRS 9 on own funds without consideration of any possible transitional arrangements.

⁹ Respondents were asked to provide estimated ranges of change in basis points for CET1 ratio and total capital ratio under IFRS 9. The averages have been calculated on the basis of the midpoint of the estimated range.

¹⁰ The maximum effect refers to the upper limit of the estimated range (minus 50 bps to minus 75 bps) provided by respondents in this range.

- It is estimated that total capital ratio will decrease, on average, by 35 bps (45 bps decrease in the first exercise), and by up to 50 bps for 76% of respondents (75 bps decrease for 79% of respondents in the first exercise). Other metrics (median¹¹ and weighted average) used for the analysis have been included in Part 2 of this report.
- Respondents confirmed that the total estimated impact of IFRS 9 on own funds is driven mainly by the impairment requirements and, to a much lesser extent, by the classification and measurement requirements of IFRS 9. The main impact on own funds seems to be driven by the estimation of lifetime ECL for stage 2 exposures (i.e. exposures that have experienced a significant increase in credit risk but are not defaulted), and mainly from loans and advances to households and non-financial corporations.
- The higher estimated impacts on own funds ratios are observed in a limited number of banks and are mainly due to the impairment requirements of IFRS 9. Most of these banks are smaller banks, which use mainly (if not solely) the SA for measuring credit risk. In contrast to IRB banks, these banks will not be able to recognise any excess in IFRS 9 provisions over regulatory expected loss (EL) in Tier 2 capital¹².
- The estimated increase in provisions compared with the current levels of provisions under IAS 39 is 13% on average¹³ (18% in the first exercise), and up to 18% for 75%¹⁴ of respondents (30% in the first exercise for 86% of respondents¹⁵).
- The estimated increase in provisions in the second exercise is lower than that in the first exercise. This may be for various reasons, such as the progress made by banks in the implementation of IFRS 9 between the two exercises, the improvement of the economic conditions and forecasts at the time the second exercise was conducted, and/or the fact that respondents were asked to estimate the absolute amount of IFRS 9 provisions in the second exercise (instead of the range of percentage changes, for which assumptions were made to arrive at an average¹⁶).

¹¹ 50th percentile.

¹² It should be mentioned that a similar situation may exist for banks using the IRB approach for measuring credit risk when they have exceeded the regulatory cap for recognising any excess in accounting provisions over regulatory EL in Tier 2 in accordance with Article 62(d) of the CRR. In such cases, these banks will not have any capital relief either.

¹³ Average means the result obtained by adding the observations and dividing the total by the number of observations.

¹⁴ This is the same as the 75th percentile. 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 To compare the responses between the exercises, 86% of respondents estimated an increase in IFRS 9 provisions of up to 22% in the second exercise (in the first exercise, the same percentage estimated an increase in provisions of up to 30%).

¹⁶ Please refer to Part 2 of this report, in which the assumptions made in calculating the averages in both exercises are explained.

2. Areas of further work — The way forward

Based on the information collected in this exercise, the third part of the report includes the EBA's detailed considerations regarding the next steps in the short term and in the medium to long term.

In the short term, the EBA considers that the recently published EBA Guidelines on ECL¹⁷ will provide guidance for banks on the robust implementation of IFRS 9. In March 2017, the EBA also published an Opinion¹⁸ on transitional arrangements and credit risk adjustments to mitigate the effect of the accounting standard IFRS 9 on prudential ratios. In its Opinion, the EBA supports a 'static approach' to the application of the transitional arrangements, based on the initial impact of IFRS 9 on 1 January 2018. The EBA also holds the view that all IFRS 9 provisions should be considered to be specific credit risk adjustments in the context of the current EBA Regulatory Technical Standards (RTS) on credit risk adjustments¹⁹. This should also enhance consistent application of the provisions of the RTS in the context of IFRS 9. In addition, the new methodology of the 2018 EU-wide stress test will take into account the implementation of IFRS 9²⁰.

At the same time, it is necessary that all the relevant key stakeholders — such as banks, competent authorities and auditors — ensure an ongoing and timely dialogue in relation to the initial application of IFRS 9. In this regard, the EBA will continue the dialogue with banks and auditors on the implementation issues observed in this exercise, and encourages banks to continue their efforts towards the high-quality implementation of IFRS 9.

In the medium and long term, the EBA considers it important that a better understanding of the various implementation practices is obtained. In this regard, a review of the implementation of the EBA Guidelines on ECL would provide insights, as would an analysis of the impact of the use of different inputs, models and methodologies on ECL measurement. In addition, the EBA will continue to be involved in discussions at the EU and international levels (i.e. with the Basel Committee on Banking Supervision (BCBS)) to explore further if any changes to the current regulatory framework on the treatment of accounting provisions may be necessary to ensure the proper interaction of the capital framework with the new ECL model for accounting.

¹⁷ <https://www.eba.europa.eu/-/eba-consults-on-guidelines-on-credit-risk-management-practices-and-accounting-for-expected-credit-losses>

¹⁸ <https://www.eba.europa.eu/-/eba-publishes-opinion-on-transitional-arrangements-and-credit-risk-adjustments-due-to-the-introduction-of-ifrs-9>

¹⁹ 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 regulatory technical standards for specifying the calculation of specific and general credit risk adjustments.

²⁰ <https://www.eba.europa.eu/-/eba-issues-2018-eu-wide-stress-test-methodology-for-discussion>

1. Introduction

Background

1. IFRS 9, which replaces the current requirements of IAS 39, was published by the International Accounting Standards Board (IASB) in July 2014 and endorsed in the EU in November 2016²¹. This report is an own-initiative project from the EBA²², following the publication of the first EBA report on the results of the impact assessment of IFRS 9²³.
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 standard²⁴. IFRS 9 is, overall, an improvement compared to IAS 39 in terms of 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 improving 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 to contribute to financial stability in the EU.
3. IFRS 9 will introduce a number of changes for banks, and the EBA is aware of the interactions between IFRS 9 and the prudential regulatory framework that need to be analysed further. In this regard, the EBA launched the first EBA exercise, surveying a sample of banks, at the end of January 2016, to obtain an understanding of the impacts of the application of IFRS 9 on institutions across the EEA, at the stage of preparation of banks at that time. The report on the analysis of the data collected, which was published in November 2016, included qualitative and quantitative observations, as well as recommendations relevant to the observations and some future EBA actions.
4. Following the publication of the report on the first EBA exercise, the EBA launched, in November 2016, the second stage of the exercise²⁵ to obtain more qualitative and quantitative information on some specific areas as banks further developed their methodologies for the implementation of IFRS 9, as well as to obtain more up-to-date and accurate information on the possible impacts of IFRS 9 and its interaction with prudential requirements.

²¹ <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=OJ%3AL%3A2016%3A323%3ATOC>

²² It is also included in the EBA's work programme: <http://www.eba.europa.eu/about-us/work-programme/current-work-programme>.

²³ <https://www.eba.europa.eu/-/eba-provides-its-views-on-the-implementation-of-ifs-9-and-its-impact-on-banks-across-the-eu>

²⁴ <http://www.eba.europa.eu/documents/10180/943157/Letter+to+EFRAG+Board+on+IFRS+9+endorsement.pdf>

²⁵ <https://www.eba.europa.eu/-/eba-launches-second-impact-assessment-of-ifs-9-on-eu-banks>

Objective of the second exercise

5. The second EBA exercise builds on the objectives of the first exercise, namely gaining a better understanding of the stage of preparation for the implementation of the Standard, the estimated impact of IFRS 9 on regulatory own funds, the interaction between IFRS 9 and other prudential requirements, and implementation issues relating to IFRS 9. The second exercise included questions that focused on more specific aspects of the main topics covered in the first impact assessment.
6. As expected, institutions have made further progress in developing the necessary capabilities for the implementation of IFRS 9 (e.g. processes, systems, models and data), and hence the quality of the information provided in this exercise is better than that received as part of the first exercise.

Sample

7. The sample was similar to that in the first exercise and consisted of 54²⁶ institutions across 20 Member States²⁷; the starting point was the institutions included in the key risk indicators 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 a range of institutions in terms of size, business model and risk profile.
8. With the exception of 1 bank, all banks provided qualitative information, and 49 banks (91%) also provided information on all the quantitative data required in the templates, which is higher than the equivalent figure for the first exercise (in which only 39 banks, or 67%, submitted all quantitative data). Part of the quantitative information required was provided by 4 banks (7%), and 1 bank (2%) was not able to provide any quantitative data at this stage. In particular, 49 banks (91%) — as in the first exercise — were able to estimate the total impact of IFRS 9 on CET1 ratio (and total capital ratio). Having said that, the response rate for the second exercise was higher than that for the first, as, overall, banks were able to provide more quantitative (as well as qualitative) information, as a result of progress made towards the implementation of IFRS 9.

²⁶ Four banks that participated in the first exercise were outside the initial selected sample, and were not included in the second exercise.

²⁷ The sample includes banks at the highest level of consolidation under the prudential scope of consolidation of the following countries: AT, BE, CY, DE, DK, ES, FI, FR, GB, EL, HU, IE, IT, MT, NL, NO, PL, PT, SE and SI.

Submissions second exercise

	Qualitative		Quantitative		Quantitative - CET1, Total capital ratio	
	Number and %		Number and %		Number and %	
All data	53	98%	49	91%	49	91%
Partial or no data	1	2%	5	9%	5	9%
Total	54	100%	54	100%	54	100%

9. In terms of the size of the banks in the sample, this exercise is similar to the first. The total assets of the banks in the sample range from approximately EUR 10 billion to more than EUR 2 200 billion. On average, respondents have total IAS 39 assets of EUR 465 billion and the 75th percentile of respondents has total assets under IAS 39 of approximately EUR 660 billion.
10. Most of the banks in the sample (94%) are identified as either global systemically important institutions (G-SIIs) (63%) or other systemically important institutions (O-SIIs) (31%). For the purpose of this analysis, it is assumed that banks with total financial assets²⁸ below EUR 100 billion are smaller banks compared with the rest of the sample. These smaller banks are mainly O-SIIs (12 out of 14 smaller banks) and the remaining 2 are neither G-SIIs nor O-SIIs.
11. Most of the banks in the sample use both the SA and the IRB approach for measuring risk-weighted assets (RWAs) for credit risk, except for eight banks that use only the SA (seven of which submitted all the quantitative data requested in the second exercise, in contrast to the first exercise, in which only four banks using only the SA submitted all the quantitative data).

²⁸ Financial assets refer to those assets classified under IAS 39 in any of the following categories: fair value through profit or loss (FVPL), loans and receivables, held to maturity and available for sale.

Submissions second exercise

	Number of banks	%
Smaller banks	14	26%
<i>Out of which using:</i>		
<i>mainly SA²⁹</i>	11	20%
<i>of which only SA</i>	8	15%
<i>mainly IRB³⁰</i>	2	4%
<i>same use³¹</i>	1	2%
Larger banks	40	74%
<i>Out of which using:</i>		
<i>mainly SA</i>	4	7%
<i>mainly IRB</i>	34	63%
<i>of which almost entirely IRB³²</i>	15	28%
<i>same use</i>	2	4%
Total	54	100%

12.Regarding the reference date used for the quantitative estimations provided, 32 banks (60%) provided data as of 31 December 2016 and 20 banks (38%) provided data as of 30 September 2016.

Submissions second exercise

Quantitative data as of	Number of banks	%
31/12/2016	32	60%
30/09/2016	20	38%
30/06/2016	1	2%
Total	53	100%

Basis for responding to the exercise

13.As in the previous exercise, the information was provided at the consolidated level of each institution in the sample under the prudential scope of consolidation.

²⁹ For the purposes of the analysis in this report, banks whose credit RWAs under the SA are more than 50% of their total credit RWAs are referred to as banks 'using mainly the SA'.

³⁰ For the purposes of the analysis in this report, banks whose credit RWAs under the IRB approach are more than 50% of their total credit RWAs are referred to as banks 'using mainly the IRB approach'.

³¹ For the purposes of the analysis in this report, banks whose credit RWAs under the SA are around 50% of their total credit RWAs are referred to as banks with the 'same use'.

³² For the purposes of the analysis in this report banks whose credit RWAs under the IRB approach are more than 80% of their total credit RWAs are referred to as banks 'using almost entirely the IRB approach'.

14. In contrast to the first exercise, where estimates were provided in ranges and using simplifications, in this exercise institutions were invited to estimate the full quantitative impact of IFRS 9 and most of the quantitative data in absolute amounts³³.
15. Banks were also informed that any publication of the information received would be on an aggregated basis. Individual information received from each institution will remain confidential.
16. 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 EBA Guidelines on ECL³⁴ and the BCBS Guidance on credit risk and accounting for ECL³⁵. Respondents estimated the impact of IFRS 9 on own funds without consideration of any possible transitional arrangements.

Structure of the exercise

17. The structure of the second exercise was similar to that of the first. In particular, the second exercise included a qualitative section and a quantitative section.

a. Qualitative section

18. Respondents were invited to provide specific responses, at a sufficient level of detail, to 23 qualitative questions³⁶ relating to the following: (a) IFRS 9 project status and governance; (b) classification and measurement; (c) impairment requirements; (d) other (including the interaction of IFRS 9 with other prudential requirements, such as leverage, liquidity and the prudential definition of default). These questions were amended and enriched on the basis of the responses analysed in the first exercise, focusing on more specific areas.

b. Quantitative section

19. The questions in the quantitative section related to, inter alia, estimates of some financial statements data and related capital adequacy figures, assuming that IFRS 9 was applied at the reference date³⁷. These estimates were differentiated in terms of changes related to: (a)

³³ Both exercises asked respondents for absolute amounts for balance sheet amounts of financial assets under IAS 39 and IFRS 9. Both exercises asked for the estimated impact on CET1, total capital, credit RWA, CET1 ratio and total capital ratio in the form of a range rather than an absolute amount. However, for provisions under IFRS 9 and the shortfall and excess in accounting provisions over regulatory EL under IFRS 9, absolute amounts were requested in the second exercise, in contrast to the first exercise, in which ranges were requested for this data.

³⁴ <https://www.eba.europa.eu/-/eba-consults-on-guidelines-on-credit-risk-management-practices-and-accounting-for-expected-credit-losses>

³⁵ <http://www.bis.org/bcbs/publ/d350.htm>

³⁶ Compared with 34 questions in the first exercise.

³⁷ Respondents estimated the impact of IFRS 9 on own funds without consideration of any possible transitional arrangements.

the impact on the balance sheet of impairment requirements (meaning the estimated exposure amounts and provisions under IFRS 9); and (b) the impact on regulatory own funds due to IFRS 9 (resulting from classification and measurement or impairment). Respondents were asked also to provide information on the distribution of financial assets in the IAS 39 and IFRS 9 asset categories.

20. In estimating ECL, institutions were asked 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.

Main assumptions and caveats

21. Like the first EBA report, this report is not an evaluation of the implementation of IFRS 9 by banks. It includes some observations on the banks' responses, which are non-exhaustive and based on the questions the respondents were asked to provide information on.

22. In the current exercise, respondents mentioned fewer assumptions and issues to be taken into account when analysing the qualitative and quantitative information provided. This was also confirmed by the responses of the banks in the second exercise; the vast majority of the banks in the sample have made progress in developing the necessary capabilities for the implementation of IFRS 9 (e.g. processes, systems, models and data). However, banks still need to finalise their processes, systems, models and data, and therefore the quality of the information provided in this exercise is expected to further improve as effective application of IFRS 9 draws nearer.

23. 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 still included certain assumptions and simplifications, compared with their finalised IFRS 9 methodology, which may not be fully consistent with the objectives of IFRS 9.

24. Finally, these estimates also depend on the existing economic environment (in which the business model of a bank is applied) and the existing business models and portfolios held by banks at the time this assessment was performed. These may change before the implementation of IFRS 9. Therefore, the observations in this report, while more accurate than in the first exercise, are still indicative of the main trends 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

25. The following part of the report includes the main observations that can be made from an analysis of the responses received. The report also includes a differentiation in the responses to consider the smaller and the larger banks in the sample or banks using the SA for measuring credit risk and banks using the IRB approach, when this is relevant.

26. In addition, when extrapolating these observations to other banks — particularly the smaller banks within the sample used — it should be taken into account that the smaller banks and banks that mainly use the SA for measuring credit risk in the sample (14 and 15 respectively) are fewer than the larger banks and banks that mainly use the IRB approach for measuring credit risk (40 and 36 respectively).

Qualitative assessment

IFRS 9 project status and governance

Degree of preparation

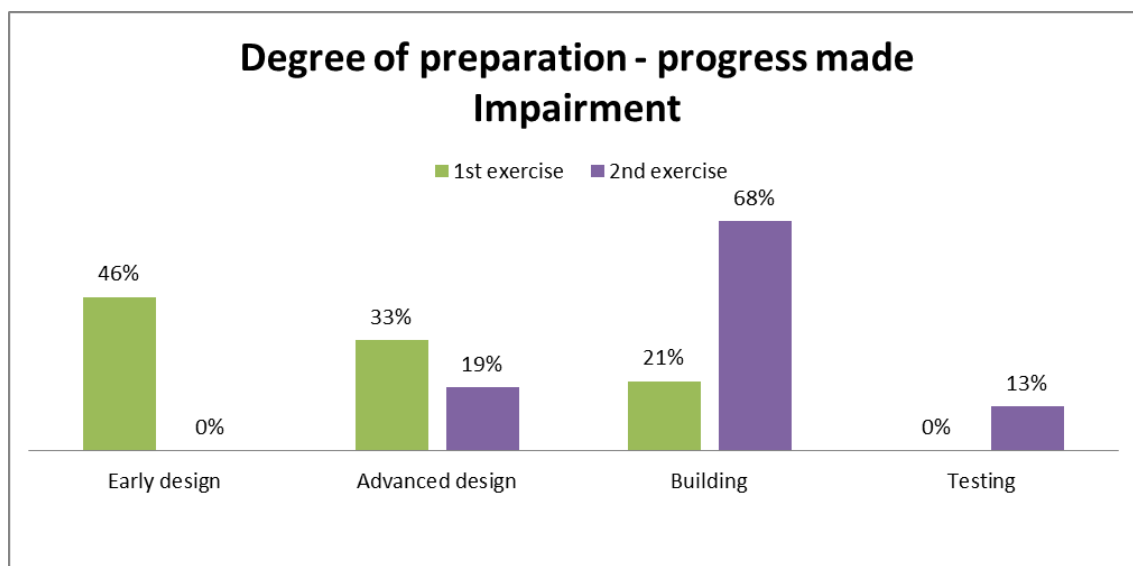
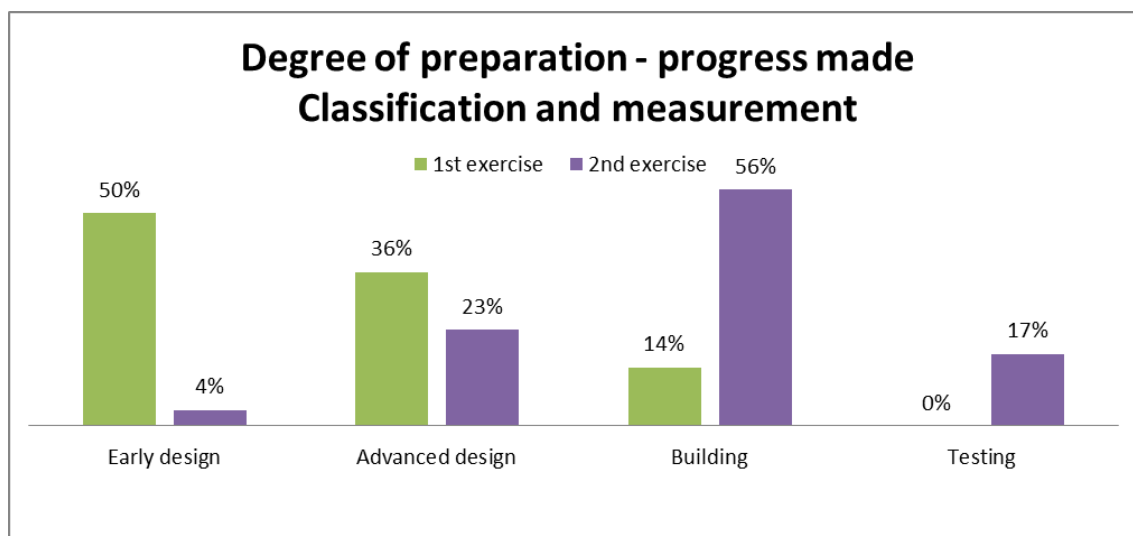
27. Banks were asked to explain what phase of implementation of IFRS 9 they were at for the various requirements of IFRS 9 (classification and measurement, impairment and hedge accounting). As in the first exercise, respondents were asked to differentiate between early design, advanced design, building and testing.

28. The figures below show the progress made for each main element of IFRS 9 between the first and the second EBA exercises.

29. **Most³⁸ banks have moved to the building phase for both classification and measurement and impairment, and a few banks have moved further forward to the testing phase.** Since the first exercise, there has been noticeable movement from the design phase to the building or testing phase of implementation. However, **a significant minority of banks are still at a designing phase (mainly advanced).** The level of implementation of IFRS 9 affects the accuracy of the estimated impact of IFRS 9 by a bank, and the outcomes of the EBA exercise.

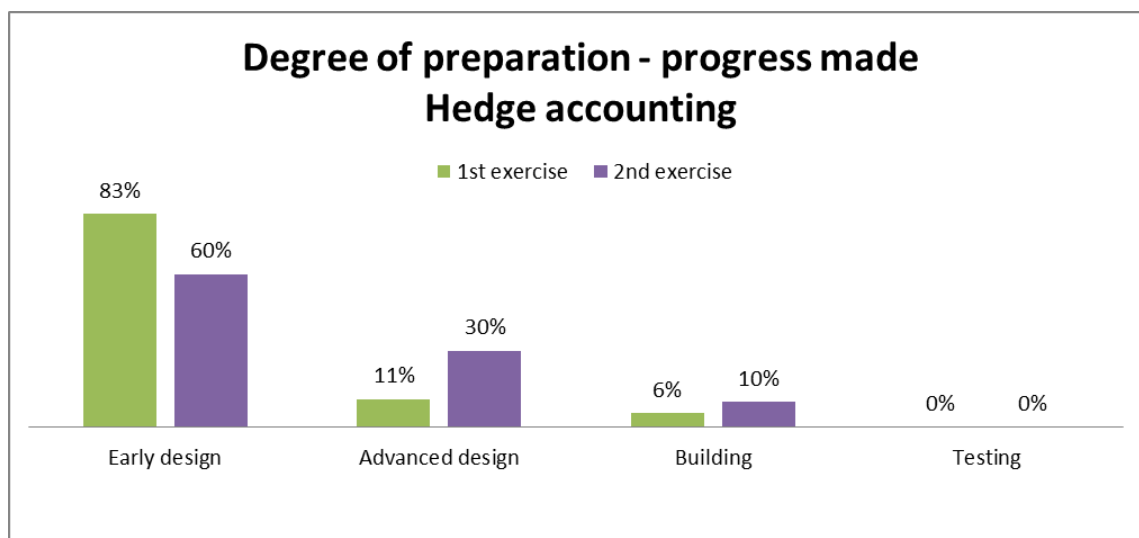
30. **Smaller banks have made progress since the first exercise,** as most of them are either in the advanced design or the building phase for both classification and measurement and impairment, whereas in the previous exercise most of them were in the early design phase of implementation. **Overall, larger banks still tend to be more advanced in the implementation of IFRS 9.** In addition, only one larger and one smaller bank in the sample are in the early design phase of implementation, and only for classification and measurement.

³⁸ 'Most' means more than 50% of respondents to the question unless specified otherwise.



31. Most banks in this survey (almost 80%) have responded **that they are planning to keep applying the current IAS 39 hedge accounting requirements³⁹** and, therefore, that they will not be applying IFRS 9 hedge accounting requirements. In the first exercise, banks mentioned that this was because they were waiting for developments in the IASB project on dynamic risk management (macro hedge accounting), considering among other possible explanations a lack of resources (where banks may be concentrating their efforts on the implementation of classification and measurement and impairment requirements). Most of the banks that are planning to apply IFRS 9 hedge accounting requirements are in the early design phase.

³⁹ 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, paragraph 7.2.21). In addition, as the IASB has not yet completed its project on 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).



EBA recommendation

The EBA welcomes the implementation efforts of banks and the progress in preparation for the application of IFRS 9. However, taking into account the limited time until initial application of IFRS 9, the EBA is concerned that some banks are not sufficiently advanced in the implementation of IFRS 9 at this stage, because some are still in the design phase and only a few are in the testing phase. This is particularly relevant for the impairment requirements of IFRS 9, where the use of extensive data and the development of new models or adjustment of the prudential models is expected, and which therefore should be tested before replacing the existing IAS 39 figures.

Although the smaller banks in the sample have advanced significantly in the implementation of IFRS 9 since the previous EBA exercise, they are still lagging behind in their preparation compared with larger banks in this sample.

It is necessary that all banks continue their efforts in implementing IFRS 9 and do not overlook parts of the new requirements (e.g. those related to classification and measurement), which may be less challenging than other parts of IFRS 9 but still require sufficient consideration and preparation for implementation.

Involvement of departments and responsibilities

32. Banks were asked to provide information on the degree of involvement of key stakeholders in IFRS 9 implementation⁴⁰ — i.e. the board of directors, audit committee, senior management and external auditors — and the role of the various departments responsible for the implementation of IFRS 9.

⁴⁰ The question differentiated between 'no involvement', 'limited involvement' (updated on a regular or ad hoc basis for information purposes) and 'active involvement' (continuously updated and decision making).

- 33. Senior management remains the stakeholder group 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. The involvement of the board of directors and the audit committee has increased but still remains more limited, and only a few banks have reported a close level of engagement with all four stakeholders. A few respondents mentioned that the board of directors and/or audit committees are not yet involved in the implementation of IFRS 9. In particular, almost all small banks have reported a limited level of involvement of the external auditors, senior management and audit committee.
- 34. As in the previous EBA exercise, the responsibility for the implementation of IFRS 9 differs between the classification and measurement and the impairment requirements of IFRS 9.** The responsibility is either held jointly by Risk and Finance (through a Steering Committee for both classification and measurement and impairment), or held solely by Risk (for impairment) or Finance (for classification and measurement). Other departments are also commonly involved, such as IT, Treasury and the business areas. Many banks have steering committees, which may take the ultimate or the most strategic decisions in the implementation of IFRS 9, or may serve as a forum for discussing the implementation of IFRS 9 among the various departments involved in the project.
35. It is understood, however, that due to the differences in the size, types of activities, business models and sophistication of banks, different approaches may be applied for the project management of IFRS 9.

EBA recommendation

The EBA welcomes the increased involvement of key stakeholders in IFRS 9 implementation. However, the EBA is concerned that in some cases — particularly for the smaller banks in the sample — key stakeholders such as the board of directors and the audit committees have not been sufficiently involved, which may lead to insufficient allocation of resources to the implementation of IFRS 9 and insufficient focus by the banks, as well as more challenges for these stakeholders in exercising their duties effectively, particularly during the transition to IFRS 9 and thereafter. In addition, further collaboration between banks and auditors in preparation for the implementation of IFRS 9 in the coming months would benefit both of these parties in effectively implementing and auditing IFRS 9, respectively.

The establishment of a Steering Committee for the implementation of the impairment requirements of IFRS 9 is considered a good practice, as it ensures that the various experts and departments are constantly collaborating, as IFRS 9 implementation requires the use of various resources and expertise. However, irrespective of the approach applied, and in accordance with principle 1 of the EBA Guidelines on ECL, the EBA reiterates its views that a clear allocation of roles and responsibilities for IFRS 9 implementation across the various departments and individuals of a bank is also necessary to ensure efficient and effective implementation. Ownership of the project by the higher levels of 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. Banks were asked if they intend to carry out any parallel runs and, if so, the intended duration of the parallel runs, and if they intend to undertake any other means to test the implementation of IFRS 9.
37. **Most banks plan to undertake a parallel run of IAS 39 and IFRS 9 before the initial application of IFRS 9 in 2018, with regard to the impairment requirements of IFRS 9.**
38. **The duration of the parallel run for impairment will be 6 months for most banks (53%) and 3 months for 11% of the banks.** Plans to perform parallel runs on impairment models and methodologies for more than 6 months are mentioned by 17% of the banks. These are all larger banks that are mainly in the building or testing phase of implementation of IFRS 9 for impairment. **It should also be noted that a significant minority of banks (19%) do not plan to undertake any parallel runs for impairment before the initial application of IFRS 9. These banks have explained that they will perform different testing exercises as the implementation of IFRS 9 progresses.**

EBA recommendation

As in the first exercise, the EBA is concerned with the duration of the parallel runs to be performed by banks to test the implementation of IFRS 9. The duration of parallel runs has been shortened from that originally envisaged. The EBA is also concerned that some banks are not planning to undertake any parallel run before IFRS 9 enters into force, and therefore encourages these banks to carry out intensive testing of their IFRS 9 processes and approaches, particularly those relating to the implementation of the impairment requirements of IFRS 9, and if necessary to consider other means to ensure the quality of implementation of IFRS 9.

In addition, the EBA considers it important that banks are able to understand and disclose, on a timely basis, explanations of the differences between IFRS 9 figures (as of 1 January 2018) and IAS 39 figures (as of 31 December 2017), together with the impact of IFRS 9 both in the financial statements and the regulatory capital. Banks should also take note of the ESMA public statement with regard to transitional disclosures to enhance the comparability of IFRS financial statements in the EU⁴¹.

More generally, once IFRS 9 is applied, disclosures will be key, as stakeholders should have sufficient information to understand and evaluate the impact of the application of IFRS 9.

⁴¹ <https://www.esma.europa.eu/press-news/esma-news/esma-prepares-new-international-financial-reporting-standard-9>

Banks should be able to understand the behaviour of IFRS 9 numbers (and the differences compared with IAS 39), and provide useful information to internal and external stakeholders.

Classification and measurement⁴²

39. The second exercise confirmed that, overall, the impact of the change in classification and measurement requirements is limited for most banks.

40. Under IFRS 9, banks reiterated their previous view that the measurement basis for financial assets — and, therefore, the balance sheet structure — is likely to remain broadly the same; amortised cost will therefore, in most cases, be the most relevant category⁴³. However, in limited cases (in both number and materiality of financial assets concerned), financial assets could be reclassified, mainly from fair value through other comprehensive income (FVOCI), under IAS 39, to fair value through profit and loss (FVPL), under IFRS 9, and to a lesser extent either from FVOCI to amortised cost or from amortised cost to FVPL.

41. It should also be acknowledged that banks have advanced in their implementation of the IFRS 9 classification and measurement requirements, as most of them are in the building or testing phase in this exercise, and therefore should have a better understanding of their balance sheet structure under IFRS 9. In addition, most respondents mentioned that they do not expect material differences in the assessment between the time the EBA exercise was performed and the initial application of IFRS 9.

Main challenges for classification and measurement

42. Respondents were asked to indicate the challenges related to the assessment of the business model for managing portfolios of financial assets and the application of the solely payment of principal and interest (SPPI) test⁴⁴. The responses provided were similar to those provided in the first exercise.

- More challenges were identified as highly significant⁴⁵ by banks with regard to the SPPI assessment than the business model assessment of IFRS 9.
- **In terms of the SPPI assessment, most respondents assessed the challenges related to the application of the SPPI test as moderate to low.** The main challenges mentioned by

⁴² 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.

⁴³ Notwithstanding the changes in provisions due to IFRS 9 impairment requirements.

⁴⁴ The SPPI assessment relates to the assessment of whether the cash flows of a financial instrument mainly represent principal and interest.

⁴⁵ A list of challenges was provided (and respondents could also add other challenges), and respondents were asked to classify these challenges as 'high', 'moderate', 'low' or 'still to be determined'.

banks were: (i) the need to perform an individual assessment for contracts with non-standardised terms (which may be burdensome and time consuming); (ii) the assessment of the cash flows of products with special features (e.g. products with prepayment options, where banks will need to assess whether these options are symmetric or asymmetric, and their significance); (iii) the benchmark test⁴⁶ (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).

- **In terms of business model assessment, most respondents assessed the challenges related to the application of the business model assessment as low.** The application of the notion of ‘infrequent and insignificant sales’ in IFRS 9⁴⁷, which is a judgemental area, remains the most relevant challenge for banks, but nonetheless it is not considered a significant challenge by the vast majority of respondents. Other challenges mentioned relate to operational difficulties in applying the requirements of IFRS 9 in particular products, such as the identification of the proportion of loans that will be sold in loan syndications and their classification in the appropriate IFRS 9 category.
- The impact of the changes in the classification and measurement requirements could depend on the type of business carried out and the products held by a bank, as those banks with plain vanilla products are expected to have limited issues in determining whether or not their portfolios are SPPI compliant. It should also be noted that, unlike in the first exercise, only a few banks have indicated explicitly that they still need to determine the challenges around the business model and the SPPI assessment, which also supports the observation that banks have advanced in their implementation of IFRS 9 classification and measurement requirements.

Estimated reclassifications of financial assets

43. In terms of the possible reclassifications of financial instruments due to IFRS 9, as in the first exercise, banks estimate that there will be reclassifications in limited cases and possibly between all categories (FVPL, FVOCI and amortised cost), but that the impact of these reclassifications will be limited for the vast majority of banks. Reclassifications have been assessed as follows:

⁴⁶ 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, paragraph 4.1.2(b)) — i.e. being consistent with a basic lending arrangement (IFRS 9, paragraph 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 where the frequency of that reset does not match the tenor of the interest rate (e.g. 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.

⁴⁷ This refers to the requirement of IFRS 9 (paragraph B.4.1.3B) according to which, 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).

- **More commonly, banks estimate movements towards FVPL** (from amortised cost or FVOCI⁴⁸ under IAS 39), **due to instruments failing the SPPI assessment** (e.g. investments in equity instruments, funds, or debt securities with specific characteristics). In addition, loans with ‘symmetric prepayment options’ may be transferred from amortised cost to FVPL depending on the outcome of the IASB’s work to amend IFRS 9⁴⁹.
- Some banks estimated movements towards the amortised cost category (mainly from FVOCI and in a few cases from FVPL under IAS 39), and a few banks estimated movements towards FVOCI (either from FVPL or amortised cost under IAS 39). 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 amortised cost (e.g. some banks referred to debt instruments of the liquidity portfolio or government bonds), or at FVOCI, or the intention of some banks not to continue applying the fair value option under IFRS 9.

EBA recommendation

Overall, it is estimated that the impact of the change in classification and measurement requirements will be limited for most banks, as in the first exercise. The impact depends on the type of business carried out and the products held by a bank, as those banks with plain vanilla products are expected to have limited issues in determining whether or not their portfolios are SPPI compliant.

Banks have identified fewer challenges than in the first EBA exercise with regard to the SPPI and the business model assessment, as a result of the further progress made in the implementation of the classification and measurement requirements of IFRS 9. However, the operationalisation of the classification and measurement requirements also requires resources and banks should not underestimate the challenges of implementing the classification and measurement requirements of IFRS 9.

In addition, the EBA considers it important that the application of the business model and SPPI assessment are issues that merit further monitoring by all stakeholders following the initial application of IFRS 9, to ensure that highly judgemental or challenging areas of IFRS 9 classification and measurement requirements are considered consistently across banks, and so that similar products in similar business models are classified and measured consistently. Such areas include the application of the notion of ‘infrequent and insignificant sales’, the application of the SPPI test in the case of prepayment options and the benchmarking of complex instruments. Finally, the EBA notes the IASB efforts in responding to the request to address the issue of ‘symmetric prepayment options’.

⁴⁸ The reference to FVOCI under IAS 39 means the available-for-sale category under IAS 39.

⁴⁹ <http://www.ifrs.org/projects/work-plan/prepayment-features-with-negative-compensation/>

Impairment

44. Banks have progressed in the implementation of their IFRS 9 ECL methodologies since the first EBA exercise was conducted, although there are still some key accounting policies and decisions to be made.

Key elements and challenges in the implementation of IFRS 9 impairment requirements⁵⁰

45. Overall, the majority of respondents consider the challenge of the implementation of IFRS 9 impairment requirements as moderate or high. The most frequently mentioned issues and challenges of IFRS 9 impairment implementation across respondents are data quality, availability of historical data, assessment of significant increase in credit risk and availability of resources, as well as the incorporation of forward-looking information in the assessment of credit risk, the transfers across stages and the ECL estimation.

- In terms of data quality and availability of historical data, the main issue described was the difficulty in determining the credit risk at origination for exposures that originated a long time ago, or for exposures under the SA. It would also be challenging to build a model for exposures for which there may be limited data or default events (e.g. exposures of high credit quality). This may require the use of proxies to determine the credit risk at origination and/or to leverage in the current IRB databases.
- Regarding the assessment of significant increase in credit risk, banks mentioned the calibration of the triggers that will result in a transfer of the exposures between stages, and the difficulties in the determination of the probability of default (PD) at origination, which is linked to the availability of data.
- Regarding the availability of resources, as banks have been making progress in the implementation of the impairment requirements of IFRS 9, this challenge is still considered significant by respondents. Some of the reasons mentioned by banks were the need to deploy the same resources for several projects (e.g. for accounting and regulatory requirements), and the difficulty of finding personnel with the appropriate skills (e.g. modelling or IT skills).
- In terms of the incorporation of forward-looking information in ECL measurement, respondents mentioned the complexity around the need to adjust the relevant ECL parameters and to develop robust models that reflect the forward-looking information and scenarios in the assessment of credit risk and ECL measurement.

⁵⁰ 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).

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 a group of exposures 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 if it does not contribute to high-quality implementation of IFRS 9 (EBA Guidelines on ECL, section 4.3.3).

The EBA acknowledges that, when processes, data, systems and models are not available, banks will use simplifications, proxies and tactical solutions to estimate ECL. The EBA believes that it is important that banks apply a sound and consistent methodology and governance process when making use of approximations in order to meet the objectives of IFRS 9, including avoiding bias. Banks should also ensure, on an ongoing basis, that the use of approximations remains appropriate, in particular if circumstances change, which may necessitate a change in the use of such approximations.

Use of existing processes, systems, models and data, and development of new models

46. Besides the intention of most banks to leverage off (to the extent possible) the existing governance processes, quality controls, data and models used in the current prudential framework and/or internally for credit risk management, banks will also build new models for measuring ECL. These include some portfolios under the IRB approach for measuring credit risk, and portfolios under the SA for measuring credit risk.

47. When developing new models banks may still leverage off the existing databases (historical data on exposures, defaults, recoveries, collaterals, etc.), credit scoring/rating and modelling techniques used for IRB or internal credit risk management purposes.

48. When leveraging off their existing IRB models or developing new models, banks referred to the following key elements of an ECL measurement:

- PD: (i) incorporation of macroeconomic scenarios; and, when the IRB is used as a starting point, (ii) 'point-in-time' estimation for IFRS 9 purposes instead of a 'through-the-cycle' estimation; (iii) conversion of 1-year PDs to lifetime PDs; or (iv) removal of margin of conservatism (i.e. conservatism in the PD estimate);
- loss given default (LGD): (i) incorporation of macroeconomic scenarios; (ii) use of the effective interest rate to discount the future estimated cash flows; and, when the IRB is used as a starting point, (iii) removal of conservative margins (to produce neutral point-in-time projections rather than downturn projections, and to exclude regulatory floors); or (iv) removal of the estimated indirect costs of realising collateral for IFRS 9 purposes;
- exposure at default (EAD): (i) consideration of the expected prepayment and the drawdown behaviour of obligors; and, when the IRB is used as a starting point, (ii)

adjustment to the credit conversion factor (CCF) model to obtain a lifetime parameter; or
(iii) removal of the downturn effect.

49. Almost half of the respondents have not decided on their processes for the validation and back-testing of the classification of exposures in the different stages and the ECL measurement (e.g. they are discussing the methodology or are in the design phase of implementation). Some respondents also mentioned their intention to rely on the existing validation processes for prudential models (e.g. stress-testing models and capital requirements for credit risk).

50. With regard to the assessment of the appropriateness of the classification of exposures to the different stages, some respondents referred to the following measures to perform this: (i) percentage of instruments classified in each stage; (ii) stability of the classification in each stage, looking at transfers from stage 1 to stage 2 and vice versa, direct transfers from stage 1 to stage 3, the average time between exposures being classified in stage 2 and then moved to stage 3; and (iii) the days past due (30 days) of exposures classified in stage 2. Besides the ECL provisions, banks also referred to the validation of each component of ECL measurement (i.e. PD, LGD and EAD). Most banks (70%) will validate and back-test the models on an annual basis and some banks will do this on a more frequent basis (quarterly or semi-annually).

EBA recommendation

Banks will use different processes, data, systems and models to estimate ECL, which may be complex and require the use of internally generated data and assumptions. Following the implementation of IFRS 9, the EBA is particularly interested in achieving a better understanding of how the differences in the factors mentioned above may affect the measurement of ECL.

The EBA reiterates its view that banks are likely to benefit from leveraging off their prudential models if, once appropriately adapted, these are fit for IFRS 9 purposes. This will allow the use of infrastructure already developed by the bank (e.g. methodologies, data and models), and allow for greater consistency within a bank (e.g. in terms of the governance arrangements used). Banks should also be able to understand the reasons for the adjustments to be made to the regulatory data, processes and/or models, and to justify the reasons for developing new models when they are not leveraging off their existing capabilities.

The EBA also notes the relevant discussions of the IFRS Transition Resource Group for Impairment of Financial Instruments (ITG) on the maximum contractual period over which the entity is exposed to credit risk for undrawn commitments and revolving credit facilities when measuring ECL for off-balance-sheet exposures⁵¹. Among other things, the ITG also noted that

⁵¹ <http://www.ifrs.org/groups/transition-resource-group-for-impairment-of-financial-instruments/>

the disclosures of the main assumptions used in the ECL measurement of some complex off-balance-sheet exposures are likely to be important to meet the disclosure objectives of IFRS 7.

In addition, it is important that banks ensure a robust governance framework of processes and controls around the IFRS 9 implementation on an ongoing basis. In this regard, the EBA reiterates its views that banks should 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 (EBA Guidelines on ECL, principle 5). Banks using existing validation processes (employed for other purposes) should make any necessary adjustments to them to ensure that the validation process is suitable for the purposes of IFRS 9 implementation. Considering also that the time for parallel runs to be performed has been reduced by most respondents, it is of great importance that a robust validation process and that regular monitoring of key elements of the models is performed to ensure the high-quality application of IFRS 9.

Methodology for ECL measurement⁵²

51. Respondents were able to provide information about the methodologies used to estimate ECL in more specific terms⁵³. The current exercise confirmed that approaches on ECL measurement will vary across banks and depend mainly on factors such as: the type of exposure (business line, such as retail or wholesale); 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. The following main trends have been observed across the sample:

- For exposures classified in stages 1 and 2, there is no clear preference among respondents for the assessment of credit losses on an individual⁵⁴ or collective basis; nevertheless, more banks will use an individual assessment for debt securities and a collective assessment for loans and advances. For exposures classified in stage 3, most respondents will assess credit losses on an individual basis.
- **For exposures classified in stages 1 and 2, almost all banks will use a $PD \times LGD \times EAD$ approach for estimating ECL, irrespective of whether the assessment is done on an**

⁵² 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.

⁵³ Banks were asked to identify by type of exposure whether they will estimate the ECL based on $PD \times LGD \times EAD$, loss rate, discounted cash flows or another approach; and whether the assessment will be done on an individual or a collective basis.

⁵⁴ With regard to the assessment on an individual basis, some respondents explained that the estimation of expected credit losses is done at a transaction level. In some cases, forward-looking information may be incorporated on a portfolio basis.

individual or a collective basis. A few banks will use other approaches such as a loss rate approach⁵⁵ (e.g. for exposures where rating/scoring information is not available, or for small portfolios), or a discounted cash flows approach.

- **For exposures classified in stage 3, most banks will assess the credit losses on an individual basis and will use a discounted cash flow approach for estimating ECL;** a few banks will use other approaches such as a $PD \times LGD \times EAD$ approach. When the assessment is carried out on a collective basis, the majority of respondents will use the $PD \times LGD \times EAD$ approach for estimating ECL, but in some cases other approaches may be used, such as a loss rate approach or a discounted cash flows approach.

52. Many banks in the sample expect that they may have to make additional adjustments (so-called overlays) in their IFRS 9 models for the ECL, as in the previous EBA exercise. However, some banks have yet to decide this as they develop and achieve a better understanding of their models for ECL estimation. Banks that expect to use adjustments will do so most commonly for immaterial exposures, to reflect the impact of any information received later in the process of ECL estimation that is not fully reflected in their models, as well as to measure ECL when there is lack of data, or to correct some model deficiencies. Overlays that are of a more permanent nature are expected to be used more commonly to apply expert judgement, to incorporate regional or portfolio-specific elements, to incorporate macroeconomic scenarios, and/or to address known model deficiencies.

EBA recommendation

Many banks expect to use adjustments on a temporary or a more permanent basis. The EBA expects that the use of adjustments will not be continuous in the long term for a continuous risk factor. If the reason for the adjustment is not expected to be temporary, as with the emergence of a new risk driver that has not previously been incorporated into the institution's allowance methodology, the methodology should be updated in the short term to incorporate the factor that is expected to have an ongoing impact on the measurement of ECL (EBA Guidelines on ECL, principle 3).

In addition, the EBA expects that the use of some adjustments (e.g. those related to shortcomings in models) will decrease over time as banks improve their methodologies. As the use of adjustments requires the application of significant judgement and creates the potential for bias, adjustments should be directionally consistent with forward-looking forecasts, supported by appropriate documentation, and subject to appropriate governance processes.

The EBA considers that, following the implementation of IFRS 9, it will be necessary to gain a better understanding of how the various approaches for measuring ECL could affect ECL measurement, as well as how the use of adjustments is likely to evolve in the future.

⁵⁵ Meaning an approach estimating the loss as a percentage of the exposure amount.

Use of forward-looking information in ECL estimation

53. Regarding the approach used to incorporate forward-looking scenarios⁵⁶ in the ECL estimation, 58% of the banks will use a probability-weighted ECL based on a number of scenarios, 17% will use a single scenario based on the most likely outcome with an adjustment (to reflect non-linear relationships between alternative scenarios and ECL), and 13% will use both approaches depending on the exposure. A few banks (6%) will use a Monte Carlo simulation⁵⁷. For the cases when a single scenario with an adjustment will be used, many respondents mentioned that they are still considering how to incorporate forward-looking information with a non-linear relationship to ECL, while others mentioned that they have accomplished this.
54. **When multiple⁵⁸ scenarios are used in the estimation of the ECL, almost all respondents expect to apply three or more scenarios for the ECL measurement of some or all of their exposures**, and respondents commonly mentioned the use of a baseline, an upside and a downside scenario. Within the bank, the number of scenarios may also vary depending on the materiality of exposures, the availability of data, the ECL methodology applied and the type of the exposures (e.g. depending on whether it is non-retail or retail).
55. **The development of forward-looking scenarios will be largely undertaken internally by most banks** (e.g. through the research or the economic department of the bank). **When developing the scenarios banks will use external, internal or a combination of internal and external sources of information.** It is also worth noting that half of the smaller banks in the sample have not yet decided on whether to use internal or external data, and whether to develop scenarios internally or purchase from external providers.
56. When referring to internal sources, banks aim to leverage off existing forecasting capabilities such as capital planning, budgeting processes, Internal Capital Adequacy Assessment Process (ICAAP) or stress-testing models, and to ensure that the inputs in the forward-looking scenarios used for IFRS 9 and in the forecast scenarios used for other purposes are consistent. Some banks also explicitly mentioned that they will consider the local specificities (to incorporate country risk drivers in global macroeconomic scenarios).
57. Some banks (15%, mainly the smaller banks in the sample) are still considering how to incorporate multiple economic scenarios in ECL measurement (including the incorporation into the PD and the transfers across the stages). For the vast majority of banks that were able to provide information at this stage, PD will be adjusted for each scenario (e.g. different PD curves used for each scenario), and staging outcomes will be defined based on the

⁵⁶ IFRS 9 requires that the measurement of ECL reflect an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes (IFRS 9, paragraph 5.5.17). The ITG has 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) (<http://www.ifrs.org/groups/transition-resource-group-for-impairment-of-financial-instruments/>).

⁵⁷ The remaining 6% of the banks have not been classified as using any of these approaches.

⁵⁸ Meaning two or more scenarios.

probability-weighted average of lifetime PDs for each scenario. Similarly, ECL will derive from the adjusted PD for each scenario together with the probability of each scenario. Fewer banks explicitly mentioned that other ECL parameters (e.g. LGD and EAD) will also be adjusted for each scenario (for instance, the expected collateral values may be different in each scenario).

58. Most banks will estimate the ECL using forward-looking information available for a time horizon of 3 years (68% of respondents) or 5 years (15% of respondents). Beyond that time horizon for which direct forward-looking information is available, most respondents to this question (60%) state they will gradually revert to a mean to determine forward-looking information (e.g. reversion to a long-run average).

EBA recommendation

Due to the extensive use of internally generated data and assumptions, as well as use of models for developing forward-looking scenarios, it is important that internally generated scenarios are appropriate. Comparison with selected benchmark scenarios, externally developed, would help a bank to ensure their appropriateness and to identify any necessary changes. When using externally developed solutions, banks should ensure that they understand and are able to explain the underlying features of these solutions, and that they are relevant for the ECL estimation.

Banks should ensure that the forward-looking scenarios include the key risk drivers that are relevant to the exposure or portfolio of exposures, taking into account the specificities of the exposure, as well as risk drivers that are relevant to the geographical location and the market of the exposure. The use of scenarios developed on a group basis should be extended to the local level to the extent appropriate, considering the need to make any adjustments to take into account local specificities.

It is important that banks are able to identify and explain the differences between the various forward-looking scenarios that may be used across the bank for different purposes, such as for capital planning or stress testing. All else being equal, there should be consistency in the estimations regarding the key risk drivers (e.g. for macroeconomic variables such as the estimated GDP) used to develop various scenarios within a bank.

Regarding the inclusion of forward-looking information on ECL measurement, banks should consider all reasonable and supportable information that is relevant to the exposure, and not rely purely on subjective, biased or overly optimistic considerations. Credit institutions should develop and document their process to generate relevant scenarios to be used in the estimation of ECL (EBA Guidelines on ECL, principle 2).

The number and types of scenarios used, as well as the methods for incorporating them into ECL measurement, is one of the key elements of the implementation of the ECL requirements of IFRS 9. Following the initial implementation of IFRS 9, the EBA is particularly interested in understanding how the factors mentioned above affect the ECL estimates, including whether

the ECL outcomes differ when using multiple scenarios (including a Monte Carlo approach), vis-à-vis a single scenario with an adjustment. In addition, the EBA reiterates that if there is a non-linear relationship between different representative forward-looking economic scenarios and their associated credit losses, using only a forward-looking scenario without adjustments (overlays) would not meet the objectives of IFRS 9 (ITG Summary, December 2015, paragraph 49, 58).

Finally, banks should carefully consider the methods that will be used beyond the period where forward-looking information is available, as different techniques may result in different results, which banks will need to be able to explain (e.g. there may be differences in the time period to revert to a mean, or the techniques used to determine the forward-looking information).

Assessment of significant increase in credit risk (transfers from stage 1 to stage 2)

59. Banks were able to provide more specific information on the use of the indicators to assess the significant increase in credit risk. Banks confirmed that they will use a combination of qualitative and quantitative indicators to assess whether or not a significant increase in credit risk has occurred.

60. In addition, most banks will base their assessment of significant increase in credit risk **more on quantitative indicators than qualitative indicators**, and different indicators may be used across different asset classes in some cases (mainly for the use of IFRS 9 practical expedients, as explained below). Expert judgement may also be used, mainly for non-retail exposures. In more detail:

- **Quantitative indicators:** Banks will mostly consider the **relative change in the PD** as a primary quantitative indicator of significant increase in credit risk for most asset classes. Another quantitative indicator commonly mentioned for assessing significant increase in credit risk was the change in the (external or internal) credit scoring or the rating of an exposure. Some banks have yet to decide on the thresholds of quantitative indicators that would need to be triggered to move the exposures from stage 1 to stage 2.
- **Qualitative indicators:** Banks will mostly consider the use of modification or forbearance and watch-list status⁵⁹ as the qualitative indicators of significant increase in credit risk. The extent of the use of qualitative information in the assessment of significant increase in credit risk may depend on how much qualitative information is already incorporated, for example through the internal rating systems or PDs.

⁵⁹ Watch-list status is more common for debt securities and loans to general governments and to credit institutions/financial institutions, as well as for loans to corporates and SMEs, than for consumer loans or mortgages.

61. **The use of practical expedients differs across asset classes** and depending on the type of practical expedient. In more detail:

- **Low credit risk exemption⁶⁰ — around half of the banks in the sample are planning to use the low credit risk exemption (as in the previous exercise) for debt securities.** In particular, it would be used for government, corporates or bank debt securities classified as investment grade. In general, banks do not plan to apply this exemption to retail loans (80% of respondents are not planning to use it for exposures to SMEs, consumer loans or mortgages).
- **The 30 days past due criterion⁶¹ —** most banks in the sample are considering applying this criterion for transferring 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.
- **The 12-month PD as a proxy for changes in the lifetime PD⁶² —** most banks in the sample are planning to use the relative change in the lifetime PD as an indicator of significant increase in credit risk. Nevertheless, between 30% and 40% are considering using this simplification and banks will tend to use it more for loans (in particular corporate loans, exposures to SMEs, consumer loans and mortgages) than for debt securities.
- **Significant increase in credit risk by comparing it to the maximum initial credit risk⁶³ —** the vast majority of banks in the sample will not use this simplification (as opposed to other possible IFRS 9 simplifications).

62. Like the larger banks in the sample, smaller banks will use the 30 days past due criterion (as a backstop) for loans and advances, and the low credit risk exemption for debt securities.

⁶⁰ 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, paragraphs 5.5.10 and B5.5.22-B5.5.24).

⁶¹ 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, paragraphs 5.5.11 and B5.5.19-21).

⁶² 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, paragraph B5.5.13).

⁶³ 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 maximum initial credit risk. However, this would only be possible for portfolios of financial instruments with similar credit risk at initial recognition (paragraph BC5.161 and illustrative example 6 of IFRS 9).

63. Banks will apply the same criteria for assessing credit risk to transfer exposures from stage 1 to stage 2 and vice versa (banks commonly referred to a symmetrical approach), and therefore once the criteria to transfer the exposures to stage 2 is not fulfilled the exposures will be transferred to stage 1. However, a significant number of banks (30%) referred to the use of a probation period when considering transferring exposures from stage 2 to stage 1, mainly for forbore exposures. The probation period may vary and could be based either on an internal management decision or the requirements of the EBA Implementing Technical Standards (ITS) on forbearance.

EBA recommendation

The interaction of the various quantitative and qualitative indicators in the assessment of significant increase in credit risk is key to meeting the IFRS 9 (paragraph 5.5.4) requirement to consider all reasonable and supportable information in ECL measurement. As banks will use different indicators for assessing significant increase in credit risk, together with IFRS 9 simplifications and expert judgement, it is necessary that there is sound governance, systems and controls in assessing significant increase in credit risk.

Banks should also carefully consider the use of different practical expedients or other proxies for the determination of a significant increase in credit risk, and assess whether or not they could provide a materially different result in the estimation of ECL.

The EBA expects that the use of the low credit risk exemption for lending exposures should be accompanied by clear evidence that credit risk is sufficiently low that a significant increase in credit risk could not have occurred when the low credit risk exemption is used, to avoid any bias in the ECL estimation (EBA Guidelines on ECL, section 4.3.3).

The EBA also reiterates that the use of the 30 days past due simplification as a backstop (for transferring lending exposures from stage 1 to stage 2) should be alongside other, earlier indicators for assessing significant increase in credit risk, in accordance with EBA Guidelines on ECL, section 4.3.3.

IFRS 9 paragraph B5.5.27 mentions that typically a customer would need to demonstrate consistently good payment behaviour over a period of time before the credit risk is considered to have decreased. Therefore, the indicators for assessing significant decrease in credit risk and the decision to transfer exposures from stage 2 to stage 1 should also address these considerations, without affecting the symmetry of the model for ECL measurement as such.

The EBA considers that, following the implementation of IFRS 9, it will be necessary to gain a better understanding of how the thresholds for triggering an indicator of significant increase in credit risk have been defined and applied across banks, as well as of their impact on ECL measurement.

Other qualitative impacts — Implications for supervisors

Interaction between IFRS 9 and prudential definitions

64. Banks provided explanations regarding the interaction of IFRS 9 with the existing accounting requirements of IAS 39 for impaired financial assets, and the interaction of IFRS 9 with the prudential definitions of default⁶⁴, and of forborne and non-performing exposures (NPEs)⁶⁵. In particular:

- **Most banks mentioned that there is no difference between credit-impaired assets classified in stage 3 under IFRS 9 and assets considered impaired under IAS 39.** A few respondents mentioned that some differences may exist, mainly because of the requirement under IFRS 9 not to consider the amount of collateral as such for classifying a financial asset as impaired, which was not clear under the IAS 39 requirements.
- **At a high level, banks will use the same definition of default for prudential⁶⁶ and for IFRS 9 purposes. In addition, most banks mentioned that exposures defaulted for prudential purposes will be classified in stage 3.** Many banks also mentioned that they will align (or are currently assessing) with the EBA Guidelines on the application of the definition of default, once they have been effectively applied. However, it needs to be acknowledged that respondents did not provide more detailed explanation on how the criteria to assess whether an exposure or an obligor is defaulted will be applied for accounting and prudential purposes (including the assessment of the ‘unlikelihood to pay’).
- **Almost half of the banks in the sample expect to classify NPEs as stage 3, in accordance with the EBA ITS on forbearance and NPEs, and 75% of the banks will include forborne exposures in stage 2 or stage 3 assets under IFRS 9,** but some differences were also mentioned, mainly related to the existence of specific prudential requirements. Examples were those related to: (i) the ‘cure period’, and related requirements before an asset is considered performing, may not be applied for accounting purposes; (ii) the additional requirements for prudential purposes to consider NPEs those exposures with forborne measures; (iii) the pulling effect for prudential purposes; and (iv) the current differences between the existing prudential definition of default and the ITS on forbearance and NPEs, which will be aligned to a large extent once the EBA Guidelines on the application of the definition of default are applied in the future.

65. Overall, at least on the initial application of IFRS 9, the vast majority of banks did not mention any additional material impact from the interaction between IFRS 9 and other prudential

⁶⁴ In accordance with Article 178 of Regulation (EU) 575/20132 and the EBA Guidelines on the application of definition of default (EBA/GL/2016/07).

⁶⁵ Commission Implementing Regulation (EU) 2015/227 of 9 January 2015 amending Implementing Regulation (EU) No 680/2014 laying down implementing technical standards with regard to supervisory reporting of institutions according to Regulation (EU) No 575/2013 of the European Parliament and of the Council (OJ L 41, 20.2.2015, p. 1), which establishes specific definitions of forbearance and non-performing exposures.

⁶⁶ In accordance with Article 178 of Regulation (EU) 757/2013 (CRR).

requirements (besides the impact of IFRS 9 on the amount of own funds), including those related to liquidity and leverage ratio. A few respondents indicated the interaction of IFRS 9 with the leverage ratio, large exposures or minimum requirements for eligible liabilities (MREL) (due to the impact of IFRS 9 on the amount of own funds or on the value of the exposures).

66. With regard to the liquidity requirements, banks confirmed that they do not expect the application of the prudential requirements on liquidity to affect the classification of their assets in the various IFRS 9 categories for classification and measurement.

EBA recommendation

The EBA welcomes the intention of respondents to align the definition of default for accounting purposes with the definition of default for prudential purposes and the consideration of the relevant prudential requirements when implementing IFRS 9 to the extent that they are relevant. The EBA also encourages banks to have a clear understanding of the reasons for any differences between the assets considered in the scope of the various accounting and prudential requirements, as mentioned previously.

With regard to the liquidity requirements, the EBA is interested in achieving a better understanding of whether assets included in the liquidity buffer are classified at amortised cost or at fair value (FVPL or FVOCI).

Impact on volatility

67. **As in the previous EBA exercise, 72% of the banks included in the survey anticipate that IFRS 9 impairment requirements will increase the volatility of profit or loss and/or own funds and/or other comprehensive income (OCI).** These include 50% of the smaller banks in the sample and 80% of the larger banks.
68. Respondents mentioned drivers of volatility in the current exercise similar to those in the first exercise, relating mainly 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, and the inclusion of forward-looking information in the ECL estimation (which will need to be reassessed at each reporting period). Regarding the ‘cliff effect’, the EBA understands that, all else being equal, when the credit risk of exposures classified in stage 1 increases (but not sufficiently to move them to stage 2), the ECL for these exposures should also increase, which should reduce the actual ‘cliff effect’ when the exposures are moved to stage 2. A few respondents (23%) mentioned that volatility may also increase because of the measurement of more financial instruments at FVPL under the new classification and measurement rules of IFRS 9.
69. However, 28% of the banks do not anticipate that the IFRS 9 impairment requirements will significantly increase the volatility in own funds and/or profit or loss, compared with IAS 39. Respondents (except one) were not able to provide any quantitative indication of the

estimated volatility on own funds and profit or loss, and some banks mentioned that they would need to carry out further analysis to understand the volatility of IFRS 9, in particular during downturns or periods of economic uncertainty.

EBA recommendation

The EBA reiterates its view that the assessment of the possible volatility introduced by IFRS 9 is an aspect that needs to be monitored. Based on the responses of the banks to other relevant questions in this survey, significant volatility seems unlikely to arise from the new IFRS 9 classification and measurement requirements (in the sense of additional volatility compared with IAS 39), because the amount of assets that will be reclassified to FVPL seems unlikely to be large. On the other hand, it is likely that there will be volatility in the profit or loss account 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. With regard to regulatory own funds, the effect on volatility will also depend on whether a bank uses the SA or IRB approach, and/or whether there is a shortfall or excess in accounting ECL over regulatory EL for banks using the IRB approach. However, it should be acknowledged that IFRS 9 should result in an earlier recognition of losses compared with IAS 39.

Impact on lending practices and long-term investments in equity instruments

70. More banks mentioned in the current EBA exercise that they do not anticipate an impact on the types, duration or the collateralisation of products offered in the market due to IFRS 9 (49% in the current exercise against 28% in the previous exercise). For those banks that anticipate an impact, the changes they see as most likely are similar to the changes mentioned in the first EBA exercise, those being related to the pricing and maturity of the products (for the impact related to the impairment requirements), and 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).

71. Regarding long-term investments in equity instruments⁶⁷, which may also be considered a means of financing the economy, while it is still early to be certain about the impact of IFRS 9 on these investments for banks, this issue may be more relevant to insurance entities, which have more equity investments held for a longer term horizon. In both exercises on the impact assessment of IFRS 9, it was observed that equity instruments represented a minor part of the financial assets of the balance sheet for the vast majority of banks (equity instruments represented 2% of the total financial assets on average and for the 75th percentile of our sample). Therefore, any impact is expected to be limited in most cases.

⁶⁷ The EBA acknowledges that long-term investment is a broader issue, but, in this report and in relation to IFRS 9, this issue has been identified in the context of equity instruments. When equity instruments are classified as FVOCI, IFRS 9 does not allow transferring the amount recognised in OCI to profit and loss when these equity instruments are sold ('recycling'). This is mainly due to the difficulty of finding an appropriate impairment model for these instruments.

EBA recommendation

The impact of the introduction of IFRS 9 on the types and duration of products offered in the market, as well as the impact on long-term investments, are aspects that merit assessment in the longer term by all interested parties, although respondents seem less concerned at the current stage of implementation of IFRS 9 of the impact of IFRS 9 on lending practices, while equity instruments (including long-term ones) are of limited relevance to banks based on the data collected from the sample.

It should be acknowledged that, besides the possible changes the new ECL model may introduce in the lending practices (e.g. price, maturity or collateralisation of the products), the new impairment model may have other consequences for banks' behaviours. These are aspects to be considered after the implementation of IFRS 9.

Quantitative assessment

Total impact on capital requirements from IFRS 9

72. The estimated quantitative impact of IFRS 9 on CET1 ratio and total capital ratio in the second exercise **follows the trend identified during the first exercise** — a lower estimated impact is observed in more cases than in the first exercise — with **no significant deviations** in the estimations of the vast majority of banks⁶⁸ and a limited impact estimated for the vast majority of banks in the sample.
73. In particular, 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.
74. **In terms of the estimation of the total quantitative impact of IFRS 9, it is estimated that the CET1 ratio will decrease, on average, by 45 bps (59 bps decrease in the first exercise), and by up to 75 bps for 86% of respondents (75 bps decrease for 79% of respondents in the first exercise).**
75. **It is estimated that total capital ratio will decrease, on average, by 35 bps (45 bps decrease in the first exercise), and by up to 50 bps for 76% of respondents (75 bps decrease for 79% of respondents in the first exercise). Other metrics (median, 75th percentile and weighted average) used for the analysis have been included in Table 1.**
76. Out of the seven banks in the second exercise that estimated a relatively high total impact on own funds from IFRS 9 (above 75 bps decrease in any of CET1 ratio and/or total capital ratio), three banks also estimated a relatively high total impact on own funds in the first exercise, one bank estimated a higher impact only in the second exercise and three banks did not provide these data in the first exercise. The higher estimated impacts on own funds ratios for all these banks are mainly due to the impairment requirements of IFRS 9. **Most of these banks (six out of seven) are smaller banks using mainly (if not solely) the SA for measuring credit risk.**
77. Having said that, the transitional arrangements being currently discussed at the EU level should help address concerns for banks with relatively high impact on own funds from the application of IFRS 9 for the coming years.

Classification and measurement

Balance sheet — Measurement basis under IAS 39 and IFRS 9

⁶⁸ It should be noted, however, that comparisons between the data provided by the banks in the two exercises have not been possible in the limited cases where banks did not provide data in both of the two exercises.

78. As in the first exercise, on average 76% of financial assets under IAS 39 are measured mainly at amortised cost (mainly as loans and receivables), 14% at FVPL and 10% at FVOCI. Under IFRS 9, the respondents also estimated limited reclassifications (and changes in the measurement methods), with 76% of financial assets under IFRS 9 measured at amortised cost, 16% at FVPL and 8% at FVOCI. Table 2 includes the median, average and 75th percentile percentage of total financial assets under IAS 39 and IFRS 9 that will be classified in the various accounting categories.
79. Banks estimated that, under IFRS 9, there would be limited reclassifications and related changes in the measurement basis. Respondents estimated reclassifications of financial instruments marginally **more frequently from FVOCI under IAS 39 to FVPL, and to a lesser extent to amortised cost under IFRS 9**. A few respondents also estimated limited reclassifications from amortised cost under IAS 39 to FVPL or FVOCI under IFRS 9. This is similar to the reclassifications estimated in the first exercise and consistent with the qualitative responses provided by the respondents in the current exercise. However, it is estimated that these reclassifications will affect a limited part of the total financial assets of respondents, on average 1%, and up to 8% in three cases.
80. **Therefore, the majority of financial assets are likely to continue to be measured at amortised cost**, and those assets that are currently measured at FVPL or FVOCI are likely to continue to be measured on those bases under IFRS 9.

Estimated impact on capital requirements from IFRS 9 classification and measurement

81. As in the first exercise, it is estimated that CET1 and total capital ratios will decrease on average by up to 4 bps and by up to 25 bps for 92% of the banks providing quantitative information on the impact of the application of the IFRS 9 classification and measurement requirements.
82. **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 impacts from the differences in the classification between IAS 39 and IFRS 9**. In most cases, these reclassifications will affect only a limited part of the total financial assets of the banks in the sample.
83. **Banks that are at the testing phase of implementation of the classification and measurement requirements of IFRS 9 — meaning at a later stage in the implementation of IFRS 9 — have estimated a higher impact on own funds from the classification and measurement requirements of IFRS 9 than banks that are at an earlier stage of implementation of IFRS 9 (designing or building phases)**. Table 3 includes the average estimated impact on own funds ratios for the classification and measurement requirements of IFRS 9, on the basis of the stage of implementation of the classification and measurement requirements of IFRS 9, and distinguishing between banks that are at an earlier stage of implementation and banks that are at a more advanced stage of implementation.

Impairment

Exposures with IAS 39 provisions

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

85. Consistent with the estimation of respondents for reclassifications, the scope of exposures for which IFRS 9 impairment requirements will apply will remain almost the same as the scope of the application of IAS 39 impairment requirements. Under IFRS 9, on average, respondents estimated a **-1% decrease in the amount of exposures in the scope of impairment requirements**, which can be attributed to the limited estimated reclassifications of financial instruments due to IFRS 9 classification and measurement requirements.

86. The allocation of IAS 39 and IFRS 9 provisions across the various types of financial instruments within the scope of the impairment requirements of each standard has been estimated, as was the case in the first exercise. In particular, most accounting provisions under both IAS 39 and IFRS 9 are allocated to loans and advances (on average 96% of provisions under IAS 39) and, within loans and advances, more specifically to non-financial corporations (on average 60% of provisions under IAS 39) and to households (on average 32% of provisions under IAS 39).

Estimated increase in provisions under IFRS 9

87. Under IFRS 9, the estimated increase in provisions for on-balance-sheet and off-balance-sheet exposures compared with the current levels of provisions under IAS 39 is, on average, up to 13% and up to 18% for 75% of respondents (in the first exercise, 18% on average and up to 30% for 86%⁶⁹ of respondents). Overall, the estimated increase in provisions for on-balance-sheet and off-balance-sheet exposures in the second exercise appears to be lower than in the first exercise, with significant deviations for a few banks that estimated a lower increase in provisions under IFRS 9 in the second exercise than in the first exercise.

88. It is worth noting, however, that, besides the progress made on the implementation of IFRS 9, which led to more accurate estimations by respondents, respondents were asked to estimate the absolute amount of IFRS 9 provisions in the second exercise (instead of the range of percentage changes in the first exercise). In particular, in the first exercise, the averages were calculated on the basis of the midpoint within the estimated range of the increase in provisions. In addition, on average for the sample, provisions under IAS 39 decreased between the first and the second exercise, while the exposures under IAS 39 on average remained stable between the two exercises. The decrease in the estimated increase

⁶⁹ To compare the responses between the exercises, 86% of respondents estimated an increase in IFRS 9 provisions of up to 22% in the second exercise (in the first exercise, the same percentage estimated an increase in provisions of up to 30%).

in provisions is allocated across all the types of exposures. The decrease in IAS 39 provisions may be due to the improvement of economic conditions, which could have also resulted in a decrease in the estimation of provisions under IFRS 9.

89. The 10 banks that estimated a relatively high increase in provisions due to IFRS 9 (above the 75th percentile of 18%) are all larger banks and mainly use the IRB approach for measuring credit risk. The estimated impact on the own funds ratios of these banks, despite the relatively high estimated increase in provisions, is lower than the respective average for the total sample. This reflects the fact that all of these banks (except one) currently recognise a shortfall in accounting provisions under IAS 39 compared with regulatory EL, and after applying IFRS 9 most of them will have an excess in IFRS 9 provisions over regulatory EL recognised in Tier 2 capital. Therefore, the existing shortfall under IAS 39 absorbs part of the increases in provisions under IFRS 9 that would otherwise impact CET1. In addition, once the increase in provisions under IFRS 9 exceeds the shortfall, these banks expect to recognise the excess in accounting provisions over regulatory EL in Tier 2 until a certain limit, above which they will not be able to have any further capital relief.

90. 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 in provisions **is mainly the result of stage 2 provisions**. In particular, on average, IFRS 9 provisions are allocated as 8%, 14% and 78% to stages 1, 2 and 3, respectively. For debt securities (including debt securities to general governments), stage 1 provisions are on average higher than stage 2 provisions, mainly due to the counterparties for these exposures (usually governments and larger corporates), whereas for loans and advances other than those to central banks, general governments and financial entities, stage 2 IFRS 9 provisions are on average higher than stage 1 provisions.

91. The estimated increase in provisions derives mainly from loans and advances to households and non-financial corporations, which it is estimated will be allocated on average 46% and 29% respectively of the total estimated increase in provisions under IFRS 9. It is estimated that these exposures will receive an allocation of IFRS 9 provisions across stages 1, 2 and 3 similar to the total exposures, being on average 9%, 19% and 72%, respectively, for households and 6%, 12% and 82%, respectively, for non-financial corporations.

Estimated impact on capital requirements from IFRS 9 impairment

92. **In terms of the estimation of the quantitative impact of the impairment requirements of IFRS 9, it is estimated that the CET1 ratio will decrease on average by up to 43 bps and 50 bps for 78% of respondents. It is estimated that total capital ratio will decrease on average by up to 33 bps and 50 bps for 82% of respondents. The impact on total capital ratio (for averages and median) is lower than the impact on CET1 ratio because the excess in accounting provisions for IRB portfolios over regulatory EL is added back to Tier 2, subject to a regulatory cap.**

93.Regarding the impact on the recognition of shortfall and excess in accounting provisions over regulatory EL, due to the increase in provisions under IFRS 9, **a significant number of banks in the sample will no longer recognise any shortfall under IFRS 9 and instead will recognise an excess in accounting over regulatory EL in Tier 2.** In particular, a shortfall in accounting provisions under IAS 39 over regulatory EL is recognised by 82% of the banks using the IRB approach for measuring credit risk, and under IFRS 9 40% of the banks using the IRB will still recognise a shortfall in accounting provisions under IFRS 9 over regulatory EL. Similarly, an excess in accounting provisions under IAS 39 over regulatory EL is recognised in Tier 2 by 53% of the banks⁷⁰ using the IRB approach for measuring credit risk, and under IFRS 9 73% of the banks using the IRB approach will recognise an excess in accounting provisions under IFRS 9 over regulatory EL.

94.**In addition, banks that are in the testing phase⁷¹ of the implementation of the impairment requirements of IFRS 9 have estimated a lower impact on own funds from the impairment requirements of IFRS 9 than banks that are at an earlier stage of the implementation.** Table 3 includes the average estimated impact on own funds ratios for the impairment requirements of IFRS 9 on the basis of the stage of implementation, distinguishing between banks that are at an earlier stage of implementation and banks that are at a more advanced stage of implementation.

95.It should be mentioned, however, that the banks in the sample that are in the testing phase of the implementation of the impairment requirements of IFRS 9 are larger banks using mainly the IRB approach for measuring credit risk, and part of the increase in provisions due to IFRS 9 may be absorbed if a shortfall in accounting provisions under IAS 39 over regulatory EL exists. In addition, compared with the other banks in the sample, these banks have estimated on average a higher increase in provisions under IFRS 9 (Table 4) and they have a lower coverage of IAS 39 provisions than the average for the sample.

Smaller and larger banks

96.**Larger banks have estimated a higher increase in provisions in terms of percentage of the existing level of provisions than smaller banks, as indicated by the average estimations for each compared with the averages for the total sample and the weighted average.** However, the higher estimated increases in accounting provisions for these larger banks did not lead (in all cases) to a higher impact on own funds than the impact on own funds for banks with lower estimated increases in provisions.

97.Besides the inherent differences in the business models of larger and smaller banks, larger banks in the sample have a lower coverage of exposures with provisions under IAS 39 than

⁶⁹ Under IAS 39, 82% of the banks have a shortfall and 53% have an excess in accounting provisions over regulatory EL (40% and 73% under IFRS 9 respectively), as a bank may recognise both a shortfall and an excess for defaulted and non-defaulted exposures.

⁷¹ Responses indicated that 13% of the banks were in a testing phase of implementation of the impairment requirements of IFRS 9. Please refer to the qualitative assessment section of the report (page 17).

smaller banks in the sample. In addition, most of the 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 EL. Indeed larger banks in the sample have, in general, a capital shortfall under IAS 39, which can 'absorb' the impact from the increase in provisions under IFRS 9. Indeed, most of the larger banks in the sample have estimated a decrease in the shortfall in accounting provisions under IFRS 9 over regulatory EL, and in many instances the recognition of an excess in accounting provisions under IFRS 9 over regulatory EL in Tier 2. On the other hand, smaller banks have estimated a lower increase in provisions but a higher impact on own funds than the larger banks in this exercise. Most smaller banks have on average lower total capital ratios than larger banks; smaller banks use mainly the SA for measuring credit risk, and there is no mechanism, such as that in the IRB approach, for a minimum impact recognised on CET1 through the regulatory EL and no means of recognising any excess in accounting provisions over regulatory EL in Tier 2 capital.

98. It is noteworthy that larger banks provided an estimates of the impact of the impairment requirements of IFRS 9 with significant concentration around the median and average values for the sample, while this was not the case for smaller banks, which estimated more diverse impacts on own funds from the impairment requirements.

SA and IRB banks

99. **As explained above, the banks that mainly use the SA for measuring credit risk tend to have a higher estimated impact on own funds from the IFRS 9 impairment requirements than banks mainly using the IRB approach, due to the current prudential treatment of provisions,** whereby the shortfall in accounting provisions over regulatory EL under the IRB approach will absorb or partially absorb the impact of IFRS 9 on own funds, which is not the case under the SA.

100. Like smaller and larger banks, banks using the IRB approach for measuring credit risk provided estimates of the impact of the impairment requirements of IFRS 9 with significant concentration around the median and average values for the sample, while this was not the case for banks using the SA, which estimated more diverse impacts on own funds.

Table 1: Summary of IFRS 9 quantitative estimations

First impact assessment 2015					Second impact assessment 2016				
Estimated increase of provisions IFRS 9					Estimated increase of provisions IFRS 9				
<i>In %</i>					<i>In %</i>				
Median ¹	20%				Median ⁵	8%			
Average ⁶					Average ⁵				
Mid of estimated range ²	18%				All banks in sample	13%			
					Small banks	5%			
					Large banks	15%			
					SA banks	6%			
					IRB banks	16%			
Weighted average ³					Weighted average ⁵	15%			
Conservative estimation in range ⁴	26%								
Midpoint of estimated range	21%								
75th percentile ¹	30%				75th percentile ⁵	18%			
% of respondents below or at the data point of the 75th percentile	86%				data point corresponding to 86% of respondents ⁷	22%			
Estimated impact on CET1 ratio IFRS 9					Estimated impact on CET1 ratio IFRS 9				
<i>In bps</i>		Total impact of IFRS 9	Classification and measurement	Impairment	<i>In bps</i>		Total impact of IFRS 9	Classification and measurement	Impairment
Median ¹		-50	-25	-50	Median ¹		-50	0	-50
Average ⁶					Average ⁶				
Midpoint of estimated range ²		-59			Midpoint of estimated range ²		-45	-4	-43
					Small banks		-78		
					Large banks		-33		
					SA banks		-77		
					IRB banks		-32		
Weighted average ³					Weighted average ³				
Conservative estimation in range ⁴		-55			Conservative estimation in range ⁴		-42	-13	-40
Midpoint of estimated range		-42			Midpoint of estimated range		-29	-5	-28
75th percentile ¹		-75	-25	-75	75th percentile ¹		-75	-25	-50
% of respondents below or at the data point of the 75th percentile		79%	88%	85%	% of respondents below or at the data point of the 75th percentile		86%	92%	78%
Estimated impact on total capital ratio IFRS 9					Estimated impact on total capital ratio IFRS 9				
<i>In bps</i>		Total impact of IFRS 9	Classification and measurement	Impairment	<i>In bps</i>		Total impact of IFRS 9	Classification and measurement	Impairment
Median ¹		-25	-25	-25	Median ¹		-25	0	-25
Average ⁶					Average ⁶				
Midpoint of estimated range ²		-45			Midpoint of estimated range ²		-35	-5	-33
					Small banks		-78		
					Large banks		-20		
					SA banks		-77		
					IRB banks		-17		
Weighted average ³					Weighted average ³				
Conservative estimation in range ⁴		-43			Conservative estimation in range ⁴		-30	-13	-29
Midpoint of estimated range		-30			Midpoint of estimated range		-18	-5	-17
75th percentile ¹		-75	-25	-50	75th percentile ¹		-50	-25	-50
% of respondents below or at the data point of the 75th percentile		79%	88%	75%	% of respondents below or at the data point of the 75th percentile		76%	90%	82%

¹ The median and the 75th percentile refer to the upper limit of a range selected from the survey.

² Midpoint 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 in the sample.

⁴ Conservative estimation is the highest value within a bank's estimated range of impact.

⁵ The median, average, weighted average and 75th percentile derive from absolute amounts of estimates (rather than estimated ranges).

⁶ The average has been calculated on the basis of the mid of estimated range.

⁷ This information has been included for comparison with the 1st exercise. In the 1st exercise, 86% of respondents estimated a 30% increase of provisions, while in the 2nd exercise, 86% of respondents estimated a 22% increase of provisions.

Table 2: Percentage of financial assets in the IAS 39 and IFRS 9 categories to total financial assets

Second EBA impact assessment IFRS 9

	IAS 39					IFRS 9			Reclassifications — movements		
	Held for trading	Designated at FVPL (FVO)	Available for sale	Held to maturity	Loans and receivables	FVPL	FVOCI	Amortised cost	FVPL	FVOCI	Amortised cost
		FVPL	FVOCI	Amortised cost							
Average	12%	2%	10%	3%	73%	16%	8%	76%	1%	-1%	0%
Median	8%	0%	10%	1%	75%	9%	7%	81%	0%	0%	0%
75th	16%	4%	12%	3%	82%	18%	12%	86%	1%	0%	0%

First EBA impact assessment IFRS 9

	IAS 39					IFRS 9			Reclassifications — movements		
	Held for trading	Designated at FVPL (FVO)	Available for sale	Held to maturity	Loans and receivables	FVPL	FVOCI	Amortised cost	FVPL	FVOCI	Amortised cost
		FVPL	FVOCI	Amortised cost							
Average	13%	3%	10%	2%	72%	16%	9%	74%	0%	-1%	1%

Table 3: Estimated impact on own funds by degree of preparation

Estimated impact on own funds by degree of preparation (in bps)⁷²

Average impact CET1 ratio	Total impact of IFRS 9	Classification and measurement	Impairment
Banks in testing phase	-38	-13	-20
Remaining population of banks	-50	-5	-49
Average impact CET1 ratio all banks	-45	-4	-43
Average impact Total capital ratio			
Banks in testing phase	-14	-13	4
Remaining population of banks	-46	-5	-44
Average impact Total capital ratio all banks	-35	-5	-33

Table 4: Estimated increase in provisions by degree of preparation

Estimated increase in provisions and impact on own funds from impairment by degree of preparation**Average estimated increase in provisions due to IFRS 9 (in %)**

Banks in testing phase	16%
Remaining population of banks	9%
Average estimated increase in provisions all banks	13%

⁷² The averages have been calculated on the basis of the midpoint of the estimated range.

3. Areas of further work — The way forward

101. This part of the report includes the recent and future work of the EBA related to the implementation of IFRS 9 by banks, particularly in terms of interaction with prudential requirements.

EBA Opinion on transitional arrangements and credit risk adjustments due to the introduction of IFRS 9⁷³

102. The EBA published an Opinion addressed to the European Commission, Parliament and Council and to all competent authorities across the EU on transitional arrangements and credit risk adjustments to mitigate the effect of IFRS 9 on prudential ratios. The EBA's Opinion builds on the Commission's proposal on transitional arrangements due to IFRS 9 in the context of the CRR/CRD review⁷⁴, as well as on the relevant discussions at the international level (BCBS)⁷⁵.

103. In its Opinion, the EBA supports the progressive recognition of the initial impact of IFRS 9 from 1 January 2018 until 2021, following the 'static' approach. The EBA Opinion focuses on the main elements that should be considered when designing the transitional arrangements. In addition, the EBA mentioned in its Opinion that all IFRS 9 provisions should be considered specific credit risk adjustments in the context of the current EBA Regulatory Technical Standards (RTS) on credit risk adjustments⁷⁶.

EBA impact assessments of IFRS 9 and future actions

104. The EBA believes that both the first and the second exercise were very beneficial for regulators and supervisors' understanding of how banks are preparing for the implementation of IFRS 9. In addition, the EBA believes that these exercises, in particular the first, helped in giving more prominence to the forthcoming IFRS 9 projects within banks and in raising awareness on the need to prepare actively, to involve the key stakeholders and to

⁷³ <https://www.eba.europa.eu/-/eba-publishes-opinion-on-transitional-arrangements-and-credit-risk-adjustments-due-to-the-introduction-of-ifrs-9>

⁷⁴ Regulation of the European Parliament and of the Council amending Regulation (EU) No 575/2013 as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements and amending Regulation (EU) No 648/2012.

⁷⁵ <https://www.bis.org/press/p161011.htm>

⁷⁶ 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 regulatory technical standards for specifying the calculation of specific and general credit risk adjustments.

allocate sufficient resources within the banks. The second exercise was also key as it confirmed several observations of the first exercise, which were at that time tentative decisions of banks rather than finalised accounting policies and methodologies. In addition, the second exercise provided more insight on the impact of IFRS 9 on smaller banks and banks using the SA, and it provided an update on the magnitude of the estimated quantitative impact of IFRS 9 on own funds, because the implementation efforts of banks were more advanced than in the first exercise.

105. Besides, IFRS 9 is a complex standard, and regardless of the impact assessment exercises performed by the EBA before its implementation, post implementation review is equally important because the full effect of IFRS 9 will be assessed comprehensively only when the standard is fully implemented by banks. It should also be recalled that the European Parliament in its resolution related to the endorsement of IFRS 9 called on the Commission, together with the European Supervisory Agencies (ESAs), the European Central Bank, the European Systemic Risk Board (ESRB) and EFRAG, to closely monitor the implementation of IFRS 9 in the EU⁷⁷.

106. In this regard, the EBA considers several actions for the short term and the medium and long term, as outlined below:

a. **Short-term actions**

- The exercise confirmed the previous observation that there are areas that require significant judgement to be applied by banks (e.g. the assessment of a significant increase in credit risk), as well as areas that might impose significant application challenges to banks (e.g. the use of forward-looking information and the availability of data). Banks have yet to finalise their processes, systems, models, data and methodologies for implementing IFRS 9 and, in this process, the recently published EBA Guidelines on ECL provide guidance for banks on the robust implementation of IFRS 9. The EBA Guidelines on ECL are expected to be applicable as of 1 January 2018 but banks are encouraged to apply them earlier to help them in the implementation of IFRS 9.
- Competent authorities are strongly encouraged to engage in dialogue with banks in their jurisdiction towards the initial application of IFRS 9, to ensure that the implementation efforts of banks remain on track and to assess any major inconsistency between the actual impact of IFRS 9 on initial application and the previously estimated impact.
- In addition, it has been already announced that the EBA, in cooperation with competent authorities, is now in the process of preparing the methodology and templates for the

⁷⁷ <http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+MOTION+B8-2016-1060+0+DOC+XML+V0//EN>

2018 EU-wide stress test, and that the new methodology will take into account the implementation of IFRS 9⁷⁸.

- The replacement of IAS 39 with IFRS 9 is a subject that is more likely to be covered in the communications between the competent authorities and auditors under the EBA Guidelines on the communication between the two parties⁷⁹. 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.
- The EBA will continue its dialogue with institutions, competent authorities and other stakeholders, such as auditors, to follow up on the results of the first and second exercises for the EU banking sector, and to discuss issues where the exercise indicated that there could be different levels of implementation.

b. Medium and longer term actions

- The implementation of the Guidelines on ECL will be followed up by the EBA to identify, for example, the provisions in the Guidelines that proved to be the most helpful and those that could be improved, enriched or detailed further.
- The EBA will also monitor implementation issues of IFRS 9, as it is likely that more implementation issues will be raised once the standard is fully implemented and a better understanding has been obtained by stakeholders.
- An important aspect will be the inputs used for ECL measurement, including the models, data and scenarios used. The EBA will liaise with relevant stakeholders, such as banks, auditors, regulators and supervisors, at the EU and international levels, in order to understand, among other things, the various practices and the effects of using different inputs and methodologies in ECL measurement (including the various models, the number and types of scenarios, and the assumptions used for the forward-looking information for the long term), the application of key judgemental elements of IFRS 9, and the effect of different governance arrangements within banks.
- As the implementation of IFRS 9 involves the use of models, and consistent with EBA work that in the field of credit risk and market risk, the EBA will reflect on the work that can be carried out with regard to the implementation of IFRS 9.

⁷⁸ <https://www.eba.europa.eu/-/eba-updates-on-the-2018-eu-wide-stress-test-timeline>

⁷⁹ EBA/GL/2016/05 (<https://www.eba.europa.eu/regulation-and-policy/accounting-and-auditing/guidelines-on-communication-between-competent-authorities-and-auditors>).

- The EBA is also closely monitoring and following up on the impact on regulatory own funds for IRB and SA banks in the context of the medium-/long-term work that is currently taking place at the international level (BCBS)⁸⁰, to explore further if any changes to the current regulatory framework on the treatment of accounting provisions might be necessary to ensure the proper interaction of the capital framework with the new expected credit loss model for accounting.
- The potential volatility of own funds merits assessment in the longer term. While it is expected that IFRS 9 will lead to a higher level of provisions, it would be worth exploring over time the behaviour of ECL provisions with changes in the economic cycle. This is a long-term task, as sufficient observations would be necessary. In addition, it needs to be highlighted that there may be other aspects leading to potential volatility of own funds, such as the removal of prudential filters for unrealised gains, in relation to which the EBA delivered technical advice to the European Commission in December 2013, in which the EBA stated that it saw advantages in the reintroduction of prudential filters for unrealised gains to the CRR⁸¹.

Other interactions of prudential requirements with IFRS 9

107. This exercise indicated some interactions of prudential requirements with IFRS 9, mainly related to the definition of default for prudential and accounting purposes and interaction with the Guidelines on the application of the definition of default and the ITS on forbearance and NPEs. Other aspects mentioned by a few banks were, as in the previous exercise, 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 counteracted by a small fraction through the reduction of the exposure measure in the denominator), and the interaction with the next stress-testing exercise. The EBA will be monitoring the possible occurrence of additional interactions during the initial implementation of IFRS 9 and beyond, to identify any emerging interaction as more knowledge and experience are obtained.

108. It is also worth noting that, although this issue is of a more limited scope than the impact of IFRS 9, 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.

⁸⁰ <http://www.bis.org/bcbs/publ/d385.htm>

⁸¹ <http://www.eba.europa.eu/regulation-and-policy/own-funds/technical-advice-to-the-commission-on-possible-treatments-of-unrealised-gains-measured-at-fair-value>



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