IFRS 9 FINANCIAL INSTRUMENTS: STATUS OF IMPLEMENTATION

At the beginning of 2017, banks have entered into the most critical phase of their IFRS 9 implementation projects. Recently some projects came under intense time pressure due to the short period left until the new accounting standard becomes effective. In this article, we summarize the implementation status of ongoing IFRS 9 projects and sheds light on how banks interpret and implement requirements in order to manage time constraints. For this purpose, we will focus on the strategic planning of IFRS 9 projects followed by a discussion on the decisions made in the separate IFRS 9 phases Classification & Measurement, Impairment and Hedge accounting.

Status and strategic planning

Currently we observe most banks in the build and test phase for both IFRS 9 Phases Classification & Measurement and Impairment while generally the former is more advanced than the latter. For Hedge accounting, most banks of the EURO-zone make use of the option to continue applying IAS 39 Hedge Accounting requirements under IFRS 9.

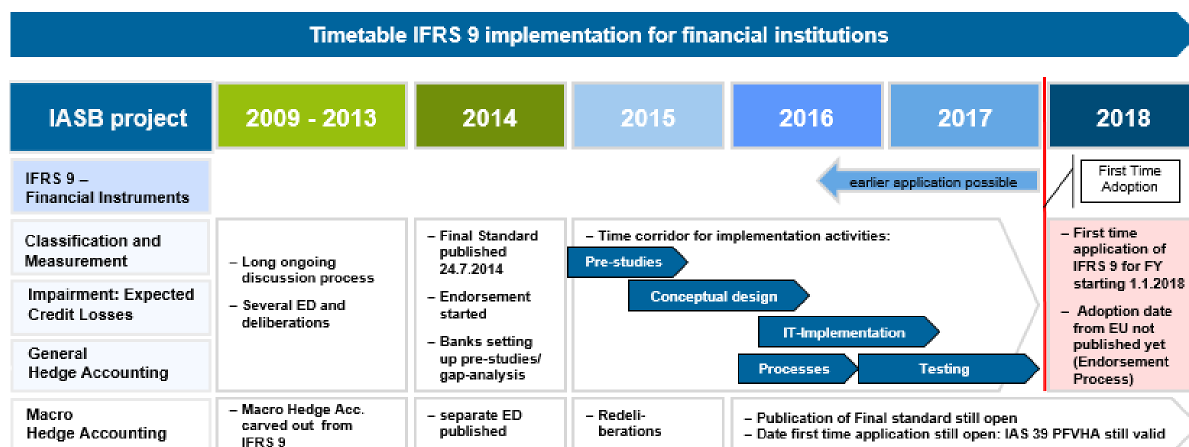

Figure 1: IFRS 9 timetable

Smaller banks are lagging behind larger banks when it comes to the status of implementation of the new accounting requirements. In some cases, we even observe that smaller banks are only in the initial stage of implementation, i.e. kicking off their IFRS 9 projects in the first half of 2017. The late IFRS 9 project initialization at smaller banks can be generally explained by lower complexity of financial instruments, accounting processes and IT infrastructure compared to larger banks. Moreover, smaller banks have limited financial resources and personnel to invest in implementation projects.

Late movers often manage the time pressure by relying on the acquisition of standardized IFRS 9-compliant accounting software from external providers. The alternatives of developing

in-house software from scratch or updating an existing accounting module is far more time-consuming and therefore is opted for primarily by large banks that have initiated their IFRS 9 projects already in 2015. Like the use of standardized IFRS 9-compliant accounting software, the use of standardized and proven project approaches might often be the key for a successful IFRS 9-implmentation. Late movers are benefitting from the experiences consultants have gained in other implementation projects.

Moreover, we observe that the later a bank has initiated its IFRS 9 project the stronger it focuses on critical requirements and postpones uncritical requirements to later stages of the implementation. Whether a requirement is considered critical depends, among others, whether a complementary business process is already in place and the relevant IFRS 9 requirement is considered an "enhancement" of the existing process. For instance, most banks have existing processes that ensure the accounting of purchased or restructured assets (partially required under IAS 39). In order to reduce implementation complexity now, these banks plan to change these processes at a later stage of the project to comply with the IFRS 9 requirements for purchased or originated credit-impaired assets and modifications.

Another factor in the criticality assessment of IFRS 9 requirements is the potential impact of a late implementation of requirements on the overall project. For example, the late consideration of the updated FINREP[1] requirements in relation to IFRS 9 would significantly increase effort and expenditures for the overall IFRS 9 project. In summary, we observe that late movers try to accelerate implementation by focusing on critical implementation requirements and reducing current complexity by using standardized implementation approaches and software.

Regardless of the size, most banks try to leverage existing processes, systems, models and data currently used for regulatory or credit risk management purposes to comply with IFRS 9 requirements. Although this may reduce implementation effort, the fit-for-purpose of the existing infrastructure is not necessarily appropriate and need to be carefully reviewed.

Classification & Measurement

We observe that the impact of IFRS 9 Phase 1: Classification & Measurement requirements do not have a significant impact on most banks. Obviously, this depends on the size of the bank, its pursued business models and the complexity of its product portfolio. For example, retail banks that hold primarily loans and advances to customers and deposits from customers will demonstrate continuity in terms of measurement categories as the majority of financial assets and liabilities will continue to be measured at Amortised Cost in the Balance Sheet. In some limited cases, financial assets will be reclassified from Loans & Receivables (IAS 39) or Available for Sale (IAS 39) to FVTPL (IFRS 9) due to failing the SPPI condition. However, reclassifications are possible in all directions and therefore all banks have to perform a through business model assessment and SPPI testing of their product portfolio to provide justification against or in favor of movements between measurement categories (incl. changes

in the respective process instructions). In addition, for larger institutes that hold non-standardized financial instruments, the individual assessment of the SPPI criterion poses the most burdensome and time-consuming exercise if implemented as automated process in the overall classification logic.

Impairment

Compared to Phase 1 requirements, the interpretation and application of some key elements of IFRS 9 Phase 2: Impairment requirement are more challenging to banks. Most banks apply a simplification available in IFRS 9 that allows using the 30 days past due as indicator for significant deterioration of credit risk since initial recognition of financial instruments. Although this simplification is supposed to be used together with other forward-looking information, we observe both smaller and larger banks to use 30 days past due as the only indicator for significant deterioration. At the same time, the IASB has expressed its concern that the days past due information is a lagging indicator, as credit risk increases significantly before a financial instrument becomes past due. Moreover, the simplification is intended as exception if forward-looking information cannot be obtained without undue cost and effort. The usage of days past due is compliant with the existing supervisory requirements on default (i.e. EU Regulation 575/2013, Art. 178). However, banks that merely use the days past due criterion may run into problems identifying performing and non-performing exposures in relation to forbearance (see EBA ITS on Forbearance and NPE).

After having implemented the 3-stage-impairment model most banks turn their attention to essential but less urgent requirements, for example, the identification and processing of purchased or originated credit-impaired assets and modifications. It is important to assess whether POCI and modification requirements are at all relevant for each particular institute and whether they can be implemented using existing data, processes and architecture.

Hedge Accounting

In relation to IFRS 9 Phase 3: Hedge Accounting the IASB gives financial institutes the choice between i) fully apply the IFRS 9 Hedge accounting requirements, ii) apply the IFRS 9 Hedge accounting to all fair value hedges of the interest rate exposure, and iii) continue to apply IAS 39 Hedge accounting requirements (IFRS 9.7.2.21). In order to reduce complexity in ongoing IFRS 9 projects most banks to make use of the third option and continue applying IAS 39 Hedge accounting. For banks that opt for implementing the IFRS 9 Hedge accounting requirements, we observe attempts to make adjustments to the existing IAS 39 processes to become IFRS 9-compliant (e.g. deactivating the retrospective quantitative effectiveness assessment).

Outlook

Regardless of the status of the IFRS 9 project, we expect implementation efforts to evolve beyond the initial application of IFRS 9 in 2018 into subsequent reporting periods due to potential audit notes and necessary process automation and harmonization. The use of standardized software solutions is for nearly all banks a preferable solution to reduce project-, implementation- and production-costs.