IFRS 9 Financial Instruments

RESULTS OF THE PRE-ENDORSEMENT QUESTIONNAIRE FOLLOW UP TO THE FIELD-TESTS CONDUCTED BY EFRAG IN 2012 AND 2013

AUGUST 2015

Contents

Executive summary

1 EFRAG and the partner National Standard Setters (ANC, ASCG, FRC and the OIC) carried out a follow-up questionnaire on IFRS 9 *Financial Instruments* from the end of November 2014 until the end of March 2015. The purpose of this questionnaire was to identify to what extent the concerns raised by constituents in earlier field-tests were still applicable after the publication of the final IFRS 9 in July 2014. Twenty-four companies participated in the questionnaire, eleven participants were from the banking industry, four participants came from the insurance industry and nine participants came from other industries.

Classification and measurement

2 A majority of participants had prepared a preliminary qualitative analysis of the classification requirements in IFRS 9. Quantitative impacts were expected over the course of 2015, 2016 or even 2017. Participants from the insurance industry noted that not knowing how the future insurance standard would look like made it difficult to make an assessment.

3 Participants from the banking industry identified which financial assets would be classified as SPPI or not as SPPI and whether this classification was, in their view, appropriate. However, only a few participants provided information on the approximate proportion of the banking book which the financial instruments represented.

4 A majority of participants from all industries expected most financial assets currently classified as loans and receivables (between 95% and 100%), held to maturity (majority or 100%) and available for sale (between 80% and 100%) under IAS 39 *Financial Instruments: Recognition and Measurement* to meet the SPPI test.

5 Participants were divided on the implications for lending practices of assessing some financial instruments currently measured at amortised cost as not passing the SPPI-assessment. Potential implications raised were reduction in maturity of the loans, reduction in the willingness to help the borrower survive a temporary distressed situation, changes in product policy and changes in asset management strategies for insurance companies.

6 A majority of participants from the banking and insurance industries were not concerned by the removal of the exemption from fair value measurement for non-quoted equity instruments for which fair value cannot be reliably determined .

Interaction between IFRS 9 and the insurance contracts standard

7 Participants from the insurance and banking industries had different views on how to resolve the interaction between two standards. All four participants from the insurance industry called for a deferral of IFRS 9 for the insurance industry or a voluntary application. Few participants from the banking industry (including one with significant insurance activities) were not in favour of delaying IFRS 9.

8 Three participants from the insurance industry provided quantitative data on the possible accounting mismatches to be identified. Those participants indicated the importance of the reclassification of financial assets from available for sale under IAS 39 to fair value through profit or loss under IFRS 9 and related accounting mismatches and provided an indication of the resulting volatility in profit or loss.

Expected credit losses

9 All participants from the banking and insurance industries analysed, at least to some extent, the impairment requirements. A majority of participants expected to have a complete understanding of the impairment requirements by the end of 2015.

10 The participants that answered this question noted that their risk management systems would be fully in line with IFRS 9 in the future whereas currently they were partly in line. However, more than half of the participants did not answer this question.

11 Some participants agreed that most of the issues identified during the field-tests in 2012 and 2013 have been addressed by the final IFRS 9. A few participants noted that most or some of the issues have not been resolved. For example, one participant from the banking industry commented that despite clarifications there would be greater operational difficulties than the implementation of IFRS as a whole. There would also be a great deal of subjectivity and a lack of comparability until the application of the standard has become mature.

12 Some participants were able to provide results of their initial quantitative modelling of the effect of IFRS 9 on loss allowances. The expected impacts on loans portfolios indicated an increase in loss allowance of between 25% and 50% for the majority. For debt securities portfolios the estimates ranged from no change to a more than 100% increase. Estimates for other financial instruments were mainly in the range 0 to 25%. The estimates on increase in the loss allowances for loans were mainly submitted by participants from the banking industry, while the estimates for debt securities, trade receivables, lease receivables and purchased or originated credit impaired receivables came from all industries.

13 In assessing the percentages above it is noted that the participants from the banking and insurance industry who provided input currently held relatively low allowances for their financial assets. Few of the participants from other industries who provided input currently held allowances with a percentage impact higher than the ones held by the participants from the banking and insurance industries and consequently expected lower increases than the participants from the banking and insurance industry.

14 Some participants from the banking industry noted that the impairment requirements would negatively affect products or pricing of financial products. The impact on longer-term and higher risk assets and would result in a reduction in, or higher pricing of, very long-term financing. Also durations would be shortened, early repayment of loans would be sought and replaced with new loan agreements. The impact related mostly to loans to corporate and retail SMEs because of lower credit rating and higher expected losses upon origination.

Costs related to the implementation of the impairment model

15 Half of the participants from the banking and insurance industries identified significant costs in implementing the impairment requirements. The rest did not comment. Almost all of the participants from the banking and insurance industries intended to leverage their existing credit risk systems developed for regulatory purposes. However significant extensions of the existing systems were estimated to be necessary. Participants from other industries did not indicate significant implementations costs.

General hedge accounting

16 Some of the participants identified areas which were still unclear or which had not been resolved by IFRS 9. Each of these concerns were mentioned by one or two participants.

17 Some of these issues related to:

(a) The application of the EU-carve out depending whether an entity continued to apply IAS 39 for its hedges or choose to apply IFRS 9 instead. The reliance on part of the Implementation Guidance from IAS 39 which was not transferred to IFRS 9 and the application of proxy hedging were raised as concerns;

(b) The need for more guidance to enable the application of hedge accounting of insurance risks under IFRS 9;

(c) The use of written options as hedging instruments in the utility industry; and

(d) The utility industry's need for a hedge accounting solution for dynamically hedging net positions.

Overall assessment of the standard

18 Some participants from the banking industry recommended that IFRS 9 be endorsed, and some recommended early endorsement. No participant recommended not endorsing IFRS 9.

Introduction

Background

1 In 2013 EFRAG and the partner National Standard Setters (ANC, ASCG, FRC and the OIC) carried out a field-test on the proposed classification and measurement requirements for financial assets contained within IFRS 9 *Financial Instruments*, as amended by the Exposure Draft *Classification and Measurement (Limited Amendments to IFRS 9).* The field-test report was published on 17 June 2013 and is available on EFRAG's website.

2 In 2013, EFRAG and the partner National Standard Setters carried out a field-test on the proposed impairment requirements in the IASB Exposure Draft *Expected Credit Losses*. The field-test report was published on 19 July 2013 and is available on EFRAG's website.

3 In 2012, EFRAG and the partner National Standard Setters carried out a field-test on the Review Draft *Hedge Accounting*. In addition a consultation was held on the transition from IAS 39 *Financial Instruments: Recognition and Measurement* to IFRS 9 for macro-hedging practices. The field-test report was published on 24 July 2013 and is available on EFRAG's website.

Purpose of the questionnaire

4 These field-tests identified a number of concerns regarding the various proposals. EFRAG and the partner National Standard Setters wished to identify to what extent these concerns still existed after the publication of the final IFRS 9 in July 2014. The purpose of the questionnaire was to gain an understanding of the extent to which concerns raised during the previous field-tests were resolved after publication of the final standard. The results from this questionnaire were used as input in drafting the [draft] endorsement advice on IFRS 9.

Approach

5 All the companies involved in the original field-test, and other companies reached through industry groups, were asked to report on the tentative results and conclusions of their internal assessment regarding the new requirements.

Companies that participated in the field test

6 Twenty-four companies participated in the field test. For the purposes of the analysis the participants from the banking and insurance industries were treated separately as accounting for financial instruments is of particular concern to them.

7 The table below summarises the number of participants by country and by industry.

Table 1: Total participants by country and by industry

Participants by country:		*Participants by industry:*	
Germany	8	Banking	11
Sweden	1	Insurance	4
France	10	Other industries	9
UK	4		
Italy	1		
	24		24

8 This report uses the following classifications to describe the findings from all respondents:

(a) Few: 1 to 4 participants;

(b) Some: 5 to 11 participants;

(c) Majority: 12 to 18 participants;

(d) A large majority: 19 to 24 participants.

Findings

Part 1: Classification and Measurement

Entity's progress in impact assessment

9 A majority of participants from the banking, insurance and other industries had initiated or finalised a first analysis of the impact of the classification and measurement requirements. One participant from the banking industry did not made an impact analysis and that participant's answers were based on expectations. The initial analysis was generally expected to be completed during 2015 or 2016.

10 The initial analysis performed was mostly of a qualitative nature, quantitative impacts were expected over the course of 2015, 2016 or even 2017 by a majority of participants. One participant from the banking industry noted that the quantitative analysis would not be made until the standard was endorsed by the EU. One participant from other industries noted that its assessment was just beginning.

11 Two participants from the insurance industry noted that not knowing how the future insurance standard would look like made it difficult to make their assessment. One of them noted it was important to synchronise the implementation of IFRS 9, IFRS 4 phase II and Solvency II in order to manage the timelines and interdependencies between the different frameworks that will affect data requirements, systems, governance and the business organisation as a whole.

General comments applicable to all categories of financial instruments

<u>*Basic lending instruments*</u>

12 The following financial instruments were seen by participants from the banking industry as basic lending instruments. For the purposes of this table, the following classifications were used:

(a) Few participants of the banking industry: 1 to 2 participants:

(b) Some participants of the banking industry: 3 to 5 participants

(c) Majority of participants of the banking industry: 6 to 8 participants;

(d) A large majority of participants from the banking industry: 9 to 11 participants.

Large majority of participants from the banking industry	Majority of participants from the banking industry	Some participants from the banking industry	Few participants from the banking industry
Financial assets with regulated interest rates	Financial assets with interest rate mismatch features	Financial assets with prepayment and call options.	Shared appreciation mortgages
Securitisation vehicles	Credit-linked products	Debt-instruments with non-vanilla features	Financial assets with derivatives bifurcated under IAS 39.
	Subordinated debt securities	Financial assets with participation features	
	Financial assets with automatic early redemption rights	Preference shares	
	Financial assets with prepayment above fair value		

Banking book assets

13 For the following financial instruments, at least some participants from the banking industry provided the information that these were held in the banking book:

(a) Financial assets with interest rate mismatch features;

(b) Financial assets with regulated interest rates;

(c) Securitisation vehicles;

(d) Financial assets with automatic early redemption rights; and

(e) Financial assets with participation features.

14 Information whether these instruments were classified as held to maturity, loans and receivables, available for sale or at fair value through profit or loss was provided by few participants but could not be aggregated.

Relevant changes to the SPPI-assessment

15 For the following financial instruments, at least a majority of participants thought that the final version of IFRS 9 brought relevant changes to the SPPI-assessment compared to the Exposure Draft *Classification and Measurement: Limited amendments to IFRS 9* reflected in the 2013 field-test:

(a) Financial assets with interest rate mismatch features;

(b) Financial assets with regulated interest rates;

(c) Financial assets with prepayment and call options; and

(d) Financial assets with prepayment above fair value.

16 For the following financial instruments, at least a majority of all participants thought that the final version of IFRS 9 brought no relevant changes to the SPPI-assessment compared to the Exposure Draft *Classification and Measurement: Limited amendments to IFRS 9* reflected in the 2013 field-test:

(a) Securitisation vehicles;

(b) Credit-linked notes; and

(c) Subordinated debt securities.

17 Only a few participants provided information on the approximate proportion of the banking book which the financial instruments identified in paragraphs 15 and 16 above represented.

18 One participant from the banking industry noted that their auditors wanted them to demonstrate the “non-significant” criteria using a regression analysis, for every interest mismatch, even the small ones. They considered this as very burdensome to implement and to update on a recurrent basis. They would have preferred a qualitative assessment for small mismatches.

19 One participant from the insurance industry was concerned that certain financings might not pass the SPPI test, where a project company owning a tangible/physical asset was to some extent refinanced via equity (30% equity ratio) and the rest (70%) was refinanced via senior debt. The amount of injected equity was calculated in a way that the senior debt achieves a certain credit rating (e.g. investment grade). Such structures were common in project finance / infrastructure debt, shipping, structured real estate financing or aircraft financing. Losses of the project company were absorbed by the equity as long as available. Only once equity was wiped out entirely, was the senior debt directly exposed to any further loss, i.e. beyond the injected equity there was no further recourse to the equity provider.

20 In the view of the participant, in these cases the exposure of the lender was not completely linked to the performance of the financed asset (which distinguished such structures from non-recourse structures). In contrast, if the performance of the financed asset was worse than as expected, the payments under the senior debt were not adversely impacted as long as there was equity available to serve as a loss-buffer and the size of the equity injected at inception was deemed to be sufficient for this type of risk and to ensure an investment grade rating of the senior debt. The participant thought that such instruments were basic lending instruments.

Other basic lending instruments

21 Some participants from other industries and the banking industry did not identify any financial assets other than those identified above which they believed were basic lending instruments and which were assessed as having cash flows that were not SPPI. One participant from the banking industry did not draw any conclusions.

22 Participants identified the following financial assets which would not pass the contractual cash flow characteristics test and which were viewed by individual participants as basic lending instruments:

(a) Managed rates with changes depending on the point in time in the business cycle as well as based on changes in the regulatory environment. These financial instruments with managed rates had expected maturities which differed from the contractual maturities wherefore the funding and the rates used for pricing were based on longer maturities than the contractual;

(b) Instruments with features that secure the upside after a restructuring;

(c) Prepayments, calls and puts that can be linked to credit events;

(d) Intercompany debt securities that have features akin to equity that were to fail SPPI;

(e) Assets indexed on constant maturity swap rate at 5 years minus constant maturity swap rate at 2 years, with both a cap and a floor; and

(f) Structures complying with the double-double test under IAS 39.

23 One participant from the banking industry noted that some commercial property finance transactions were still to be assessed in more detail. One participant from the banking industry still had to assess the possible interest rate mismatches in their portfolio, the contractual terms in their non-recourse loans and the trigger and consequences of the covenants in the their loans portfolio.

Other banking book assets

24 Some participants from other industries and the banking industry indicated that they did not hold a significant number of financial assets which they viewed as basic lending and/or were managed in the banking book but that were unlikely to be assessed as meeting the SPPI -test.

25 One participant from the banking industry thought financial assets embedding closely related derivatives should have cash flows that met the SPPI test.

26 One participant from other industries noted that investments in open-ended money markets or debt funds would not pass the SPPI test.

Qualitative impact assessment

27 Few participants from other industries and the banking industry noted that they did not hold a significant number of financial assets that they viewed as being basic lending instruments and/or managed as part of the banking book but were unlikely

to be assessed as meeting the SPPI test. One participant from the banking industry expected that constant monitoring based on the shape of the yield curve would be necessary.

28 One participant from the insurance industry mentioned that investments held in special funds with the main objective being to promote the local economy which would not pass the SPPI test.

Implications for lending practices

29 Few participants from the banking industry noted they would not change their contracts due to the SPPI requirement or did not view the impact on lending practices as a concern given the simple nature of most banking book assets. One of those participants noted that the impairment chapter of IFRS 9 would create incentives to reduce the maturity of loans as well as a reduction in the willingness to help the borrower survive a temporary distressed situation.

30 Few participants from the banking industry noted it was too early to make this assessment; one of those participants noted that the product policy could be changed if the downside or the administrative costs were greater than the upside of changes in credit risk.

31 One participant from the insurance industry noted the classification and measurement requirements could influence asset management strategies if due to a less favourable accounting treatment (i.e. resulting in profit or loss volatility) these investments would appear less attractive. They might reduce their exposure in asset classes like equity and non-traditional debt instruments which lead to fair value through profit or loss.

32 One participant from the banking industry advocated for a preliminary quantitative impact study (QIS) to be launched at the European level. Such a QIS would be used to inform the European Commission, the Council and the European Parliament about the expected consequences of IFRS 9 on banks' equity.

Proportion of IAS 39 balance sheet category to be assessed as SPPI or not SPPI

33 A majority of participants from the banking, insurance and other industries estimated the number of financial instruments currently classified according to IAS 39 meeting the SPPI test to be within the following ranges:

	Expected to be assessed as	
IAS 39 classification	**SPPI**	**Not SPPI**
Loans and receivables	Between 95% and 100%	Between 0% and 5%
Held to Maturity	Majority if not all or 100%	0%
AFS debt instruments	Between 80% and 100%	Between 20% and 0%

34 One participant from the insurance industry provided quantitative data which did not contradict the above trends. Another participant from the insurance industry noted that their data were broadly in line with the above trends but noted that nevertheless they would suffer significant volatility as a result of financial assets currently held at available for sale which would fail the SPPI test. That participant clarified that those financial assets would fail the SPPI test because of the following features: (i) callable, puttable, convertible features, (ii) fix-to-float coupon with no-linear triggers, (iii) other than plain constant-maturity-swap or constant maturity treasury, inflation linked and (iv) some asset backed and other structured products.

35 Some participants from the banking, insurance and other industries noted that they were not able to make the above assessment, did not reply or were still doing the assessment.

Financial assets – equity instruments

36 A majority of participants from the banking, insurance and other industries were not concerned that the exemption from fair value measurement for non-quoted equity instruments for which fair value cannot be reliably determined had been removed. One participant from the banking industry noted that if the instrument was material it was to be measured at fair value, and not having the exemption made sense. One participant did not use this exemption.

37 Some participants from other industries viewed the impact of removing the exemption from fair value measurement as significant. One of them estimated the carrying amount of those investments as 1.5% of their balance sheet in 2012. Another one estimated the carrying amount of these investments as 2.5% of the balance sheet in 2014. One participant from other industries noted the impact was significant on a practical basis, not in amounts. The reason for this, as supported by all of the above participants, was that it was usually not possible to gather the required information to perform a reliable and timely fair value calculation where a company invests in equity securities of non-publicly listed companies without gaining significant influence or control. Removing the exemption would lead to significant judgement and the loss of objectivity.

38 One participant from the banking industry noted that the option to measure equity instruments at fair value through other comprehensive income would not be extensively used because fair value changes other than dividends cannot be recycled in profit or loss. In contrast, the fair value through profit or loss category would be used, even if it did not reflect the long-term investment business model. The participant concluded that IAS 39 was more relevant for equity investment activities than IFRS 9 on this particular point.

Other comments

General comments

39 One participant from the banking industry noted that any change in measurement categories between IAS 39 and IFRS 9 was expected to be marginal.

The interaction between IFRS 9 and the new insurance contracts standard

QUALITATIVE INPUTS

40 Participants from the insurance and banking industries had different views on how to resolve the interaction between the two standards:

(a) all four participants from the insurance industry thought that IFRS 9 should be deferred until the new insurance contracts standard becomes effective. One of these participants considered that such a deferral should be optional. Their concern was the usefulness of financial reporting for users in the period between the application of IFRS 9 and the new insurance contracts standard, as stakeholders would experience two major changes in an insurer's financial statements in short succession;

(b) one participant from the banking industry with significant insurance activities called for a mandatory application of IFRS 9 by all entities at the same time; and

(c) one participant from the banking industry was not in favour of delaying IFRS 9, but wanted the IASB to consider the ability for insurance companies to reassess the classification of their asset portfolios they will have made under IFRS 9, when they will first apply the new insurance contracts standard.

41 One participant from the insurance industry noted that earlier (than new IFRS 4) application of expected credit losses' model would be more costly to insurers than to the other industries for the following reasons:

(a) complexity of and intertwining with other reporting; and

(b) necessary re-assessment of classifications and therefore duplication of efforts and costs.

QUANTITATIVE INPUTS

42 Of the participants from the insurance industry, three participants provided quantitative data on the possible accounting mismatches to be identified. Those data were difficult to aggregate for the following reasons:

(a) Different assumptions were used to support the data. For example, the stress scenario relied upon or the historical period referred to document the volatility; and

(b) For debt instruments failing the SPPI-test not enough comparable data were available to aggregate.

43 Those participants noted that the adoption of IFRS 9 would lead to more measurement at fair value through profit or loss compared to IAS 39. This effect was caused by:

(a) Equity instruments (including limited partnership interests and investment fund units) and non-bifurcated compound investments currently classified as available for sale under IAS 39 being measured at fair value through profit or loss under IFRS 9;

(b) Some securitisation structures (such as asset backed securities or mortgage backed securities) might not pass the SPPI test; and

(c) Structured products or bonds which did not pass the SPPI test.

44 One of the participants noted that, based on a representative sample basis, for other debt instruments (such as government, corporate or covered bonds) the cash flow characteristics test would largely be met, and only about 1% of the financial instruments would not pass the cash flow characteristics test. This outcome would be in line with the analysis by the majority of participants in paragraph 33 of this questionnaire. However, the participant cautioned that their analysis was only indicative and had to be undertaken in more detail. Another participant from the insurance industry noted that their data were in line with the analysis provided in paragraph 33 of this questionnaire but that they would suffer significant volatility as a result of financial assets currently held at available for sale which would fail the SPPI test.

45 As a result of the above, those participants indicated that they would encounter:

(a) Reclassification of financial assets debt instruments from available for sale under IAS 39 to fair value through profit or loss under IFRS 9 which varied from 2.5 to 5% of total assets to 24% of the 2014 net result; and in addition

(b) Significant volatility in profit or loss at the times of financial crises due to the reclassification of equity instruments from available for sale to fair value through profit or loss, with average ranges from minus 66% to plus 65% of net income. These ranges should be read with the comments which were made in paragraph 42(a) above in mind.

Treatment of investment funds from an investor's perspective

46 One participant from the insurance industry raised the issue of how units of investments funds should be classified from an investor's perspective under IFRS 9:

(a) Which units can be put back to the issuers (puttable instruments) or which will definitely be paid back at predetermined date (limited lifetime funds); and

(b) Which units are currently classified as available for sale under IAS 39.

47 Under IFRS 9, such financial instruments can be classified at fair value through profit or loss but the question was raised as to whether such financial instruments could also be classified at fair value through other comprehensive income.

48 One participant from the insurance industry noted that the restriction on recycling and the absence of impairment for equity instruments measured at fair value through other comprehensive income (FVOCI) was not appropriate as realised gains and losses and impairment on these assets were part of the performance of the related insurance portfolios. The limitation of the use of FVOCI by IFRS 9 would make it difficult for insurers to reflect the performance of their asset and liability management strategies which included using diversified categories of assets, including derivatives, to manage interest rate risks or credit exposures.

Determination of the business model: specific cases

49 One participant from the banking industry noted a business model issue on portfolios managed as held for sale. The participant noted that it was difficult to segregate assets that can be sold from those that they intended to keep as there was no market or market conditions were changing. The participant regretted that amortised cost for such illiquid assets was no longer possible.

50 One participant from the banking industry did not support the concept of FVOCI with a prohibition on recycling from OCI to profit or loss when impairment or disposal occurred. This was because it resulted in a misrepresentation of the performance in the income statement for non-trading equity investments.

51 One participant from the banking industry found it difficult to identify at origination which loans would be sold to a non-consolidated securitisation special purpose vehicle. This could trigger a mixed model choice with FVOCI valuation to all loans that may be subject to securitisation whereas the majority of the loans would meet the hold to collect contractual cash flows business model. The participant noted that it was operationally difficult to make the choice at origination as securitisation also depended on market conditions.

Long-term business models – rate regulation

52 One participant from other industries noted that the classification and measurement principles did not reflect their long-term investing activities to finance their long-term obligations. In order to secure financing of their long-term obligations (e.g. the decommissioning of nuclear power plants and the long-term management of radioactive waste), the participant managed a portfolio of dedicated assets composed of equity securities, bonds and shares of mutual funds, partially hedged against currency risk. These financial instruments are currently held as available for sale under IAS 39. The disappearance of the category would create a significant fair value volatility in profit or loss of around 1 billion euro instead of in other comprehensive income as at present. These long-term investing activities differed

from the long-term investing activities of insurance companies as the latter activities relied on matching insurance liabilities with covering assets.

Part 2: Expected Credit Losses

Current status of IFRS 9 implementation

53 All participants from the banking and insurance industry had, at least to some extent, addressed the IFRS 9 impairment requirements. Few of the participants from the banking industry started their assessments in 2012 and 2013 based on the draft standards. Participants described their progress using the following terms:

(a) An overall assessment has been made;

(b) Pre-study has been completed;

(c) Policies were developed and models designed; and

(d) High level business and IT impacts have been made.

54 All participants expected to have a materially complete understanding of the impairment requirements as follows:

Ready now	2015	2016	2017	2018	No answer
2	10	3	2		7

Risk management systems

55 Some participants from the banking, insurance and other industries indicated that their risk management systems were currently partly in line with IFRS 9. With one exception, those participants expected their risk management systems to be fully in line with IFRS 9 in the future.

	Currently	In the future	
Fully in line with IFRS 9		10	
Partly in line with IFRS 9	10	1	
Not in line with IFRS 9	1		
no reply			13

56 The participants added the following:

(a) Participants from the banking and insurance industries noted that their target was to leverage the existing regulatory methods in order to achieve consistency between the regulatory and the accounting model. Also they intended to leverage stress test methodologies. Significant extensions of the existing systems were expected to accommodate the current and forward looking information and adjust the existing regulatory risk parameters based on through-the-cycle or downturn perspective.

(b) Existing risk management systems were assessed to be less straightforward for credit deterioration tracking. Adjustments were expected to be necessary to measure the default risk on instrument rather than counterparty basis.

(c) One participant from other industries noted that they expected to be able to estimate the expected credit losses using their historical credit loss experience.

(d) One participant from the banking industry noted that the forward looking information was already taken into account in individual ratings of wholesale clients. For retail portfolios prospective information might not be reflected in risk management individual metrics and a collective approach might be a solution to this.

(e) One participant from the banking industry noted that their internal risk management system for credit risk was not based on managing credit risk as defined in IFRS 9 since they do not believe that IFRS 9 will produce relevant estimates for the inherent credit risk in the portfolios. They added that there was a need to develop separate models or to build on regulatory reporting systems and Basel models which will be modified and enhanced.

Costs of IFRS 9 implementation and application

57 Some participants from the banking and insurance industry mentioned the following implementation costs:

(a) The main cost was expected to be building new specific IFRS 9 calculators and models which will sit within current reporting systems which in some instances will require significant enhancement.

(b) Significant IT costs to meet comprehensive disclosure requirements, tracking of credit risk by comparison between the reporting date and origination date may change significantly current systems design and storage capacity.

(c) Significant costs for related to the new requirements for modifications and complex roll-out of cash flow tables.

(d) Costs related to reconciliation between Basel and IFRS 9 parameters.

(e) Additional system capability and capacity will be put in place, building on the existing regulatory reporting systems and stress testing systems. These systems are themselves undergoing further development to meet a variety of new regulatory requirements. While the costs are not insignificant, they believe the overall benefits in terms of financial reporting providing useful information will exceed the costs.

(f) Regarding the debate on the Basel guidance, a proportionate and materiality approach for small portfolios should be recognised in order to use practical expedients.

58 One participant from the insurance industry noted that analyses had to be performed in order to estimate the implementation cost and effort and following items had to be accurately analysed: group internal standard for the impairment model, definition of granularity of the assets, managing internal / external data into back office systems. They were considering setting up an internal rating model for assessment of probability of default on non-rated/non-quoted financial assets and associated costs were expected to be high if alignment of IFRS 9 and the new insurance contracts standard was not achieved. The reason was that there would be a need to go for an item-by-item application even though vast majority of assets were investment grade. The prospective impairment based on expected default and expected recovery suggested high costs of processing and documentation.

59 Some participants commented on ongoing costs, all of them from financial industries. Few participants from the banking industry did not expect ongoing costs significantly higher than in the current practice. One participant from the banking industry expected a significant increase in the ongoing costs mentioning specifically costs for parameters validations and IT systems. Another participant from the banking industry was not able to estimate the ongoing costs at this stage. Finally, another participant from the banking industry noted that, due to macroeconomic

factors to be considered, their model would have to be reviewed on a regular basis for segmentation, calibration and transfer criteria.

60 Few participants from the banking and insurance industry identified the implementation efforts in terms of man-days and the estimates ranged from 25.000 to 40.000 man-days.

Comments on EFRAG staff assessment of how the issues identified in the previous field test have been addressed by IFRS 9

61 Some participants expressed support for the EFRAG staff's tentative view that most of the issues identified during the field test have been addressed by the final IFRS 9. Some provided additional comments:

(a) One participant from the banking industry noted that, regarding the issue of significant increases in credit risk, the examples given in the Implementation Guidance for the assessment of significant increases in credit risk were overly simplistic. Regarding the use of information available without undue cost or effort, it would be helpful if also relevance and reliability of information were emphasised to avoid the operational burden of having to capture an extremely broad set of data.

(b) One participant from the banking industry commented that there remained scope for interpretation of IFRS 9 and as such, additional regulatory guidance, as well as the role of audit firms, was expected be key but must be consistent with the requirements of IFRS 9.

(c) One participant from the insurance industry mentioned that the issues were a matter of application of the new requirements in an appropriate way and did not believe that more guidance was necessary from a principle-based standard perspective.

62 One participant from the banking industry was in disagreement and in their view most of the issues had not been resolved. For example they objected to the conclusion that IFRS 9 resolved the problems in relation to:

(a) Applying the proposed definitions of 12-month and lifetime expected credit losses. They noted that there will be operational difficulty for all entities regardless of available IT systems and loss data. This risk was a heavier burden than the implementation of IFRS as a whole for financial institutions since it will affect all loan portfolios within a bank involved in traditional banking book business.

(b) Determining the principle of transfer between 12-month and lifetime expected credit losses, providing allowances for revolving credit products and purchased credit impaired financial assets. For all of these, they commented that there will continue to be a great deal of subjectivity in the assessment, but they did not believe that further guidance would help. Instead this would need to be developed during the years and therefore there will be a lack of comparability until "the standard have become mature".

63 Some participants were not specific in expressing their support or not on the EFRAG staff's assessment but they provided specific comments:

(a) One participant from the insurance industry noted that operational concerns were still valid especially for large portfolios of corporate debt instruments that had little to no historical experience on a shared risk characteristics.

(b) One participant from the banking industry commented on following issues:

(i) The issue concerning purchased/originated credit impaired was not entirely resolved since paragraph B5.5.26 seemed to indicate that there could be situations when the substantial modification of a distressed assets that results in derecognition of the original financial asset could result in the new financial asset not being credit impaired at initial recognition. This seemed inconsistent with the definition of a credit-impaired financial asset in Appendix A.

(ii) Regarding the issue on the alignment of effective dates of IFRS 9 and the new insurance contracts standard, if the effective date of the new insurance contracts standard was later than IFRS 9, entities should be permitted not only to re-open their fair value option decisions but also their business models to allow reclassification between amortised cost and FVOCI as a new transition approach.

(iii) Regarding the issue on modifications (all modifications treated in the same way), it may be that commercial modifications that do not result in economic loss result in derecognition and therefore there was no need to recalculate cash flows. Given that the borrower could just pay off the loan and go to another lender in these circumstances (but not if in financial distress) and derecognition is a matter of judgement, this seemed a reasonable interpretation.

(c) One participant from the insurance industry noted that:

(i) Some of the disclosure requirements, especially the quantitative ones, were still burdensome from an operational perspective and were not estimated to be useful to the readers of financial statements; and

(ii) They did not follow the interpretation that IFRS 9 requested a point-in-time approach for the calculation of expected losses and for the measurement of credit risk. In their view IFRS 9 did not require a point-in-time approach but instead required the use of current information as of the reporting date.

(iii) There was ongoing discussion on whether the loss allowance measured at 12-month expected losses has to be recognised at initial recognition or at the reporting date. Another point which was not clear related to whether the 12-month expected losses may be measured at portfolio level.

(d) One participant from the banking industry commented that recognising gain or loss on modifications resulting from commercial renegotiations did not result in relevant information

(e) Another participant from the banking industry noted that discussions on the Basel Committee on Banking Supervision guidance were a good example of implementation concerns remaining even if the IASB had already clarified some implementation issues.

Analysis of impact of expected credit losses

64 Only some participants from the banking, insurance and other industries provided quantitative estimates of the impact of expected credit losses on their existing loss allowances. The following table summarises:

(a) quantitative impacts of the IFRS 9 impairment model on the volume of loss allowances based on initial modelling; and

(b) any intention to use the transitional relief.

	Relief		Lower		Higher				
Type of portfolio	N	Y	>25%	0-25%	0-25%	25-50%	50-75%	75-100%	>100%
Loans to local, regional and central governments	1				1	1			
Loans to corporates	2				1	2		1	
Loans secured on real estate property	2					3			1
Retail loans	2					2	1		
Loans to credit institutions and investment firms	1				1	1			
Other loans	1				2	1			
Total loans	1	1			1	2			1
Debt securities (making use of external ratings)	1	1			1	1			2
Debt securities (making use of internal ratings)	1	1				1			2
Purchased or originated credit impaired assets	1	1			2				1
Lease receivables	1	1			3				1
Trade receivables	1				4				1
Financial guarantees and loan commitments	1	1			1	1			1

65 The expected impacts on loans portfolios were, in most cases, an increase between 25% and 50% of impairment allowances. For debt securities portfolios the estimates ranged from minimal change to a more than 100% increase. Estimates for other financial instruments were mainly in the range 0 to 25%.

66 The estimates on increase in the loss allowances for loans were mainly submitted by participants from the banking industry, while the estimates for debt securities, trade receivables, lease receivables, purchased or originated credit impaired receivables came from the banking, insurance and other industries.

67 One participant from the insurance industry provided estimates of more than 100% consistently for all the items (with loans restricted only to total loans) with a note that the IAS 39 loss allowances were very low (e.g. no provisions for bonds) and the IFRS 9 allowance for expected credit losses would be around one to two percent of the net equity, using parameters applied for regulatory purposes. Other estimates of increases of more than 100%, i.e. for loans secured on real estate property and debt securities, came from participants from the banking industry.

68 In assessing the importance of the percentages above it is to be kept in mind that the participants from the banking and insurance industry who provided input to the above table currently held relatively low allowances for their financial assets. Few of the participants from other industries who provided input to the above table currently held allowances with a percentage impact higher than the ones held by the participants from the banking and insurance industries and consequently expected lower increases than the participants from the banking and insurance industry.

69 For the participants from the banking and insurance industries the overall amounts of allowances would remain relatively low even when taking into account the percentage increases. Hence the impact on present capital requirements for those

entities was expected to be significantly lower than the percentage impact on the allowance amounts reported by the participants. Capital requirements follow the economic lending cycle hence the impact on future capital requirements may be different.

70 Some participants provided a qualitative assessment rather than quantitative estimates such as:

(a) Participants from the banking industry:

(i) expected an increase in loss allowances especially in long-term financing as approximately two thirds of the portfolio was not investment grade. Non-investment grade loans such as SME loans were expected to be more affected than investment grade loans;

(ii) financial impacts were expected to be significant and more volatile than under IAS 39 but would depend on the economic outlook at the implementation date and thereafter; and

(iii) provisioning was likely to be more volatile, and the impairment model will be more costly for new portfolios.

(b) Participants from the insurance industry:

(i) expected allowances to be higher; and

(ii) for debt securities which constitute their main exposure, noted that it was not possible to estimate the quantitative impact currently but significant increase was expected only if starting from a low starting point. For other financial assets the impact should not be material.

(c) Participants from other industries:

(i) did not expect the impact on trade receivables to be important as the current methodology was not significantly different to IFRS 9 requirements. Quantitative assessment had not started for other financial assets; and

(ii) did not necessarily expect an impact for trade receivables as depreciation matrix was already used although a transition impact was probable since the trade receivables are currently not depreciated before they are 30 days past due. As regards long-term IFRIC 4 *Determining whether an Arrangement Contains a Lease* and IFRIC 12 *Service Concession Arrangements* receivables significant impact was not expected as they had state-owned counterparties and there had been no collectability issues on them in the past and their risk was considered very low even from a long-term perspective.

71 Few participants provided information about expected use of the transitional relief in allocating the exposures to Stages 1 and 2 based on an assessment of having low credit risk or not. One participant from the insurance industry intended to use this exception. Few banks did not intend to use the transitional relief, one of them specifying it would be used only this for loan portfolios.

Impact on products and pricing

72 Majority of the participants provided some comments about the expected impact on the availability of specific financial products and/or their pricing.

73 Few participants from the banking industry expected that there would be a negative impact. They saw it in a reduction in, or higher pricing of, very long-term financing. Other impacts mentioned were shortening of durations, asking for early repayment

of loans and replacing them with new loan agreements, lending market drying up early in a downturn business cycle with a risk of worsening a financial crisis.

74 Some participants from the banking industry commented that a negative impact on products or pricing was possible. They specified impacts on longer-term and higher risk assets (such as SME and corporate loans). Furthermore potential negative impacts might be expected due to effects on capital especially under adverse economic conditions.

75 One participant from the banking industry stated that there would be no impact.

Other comments

76 One participant from the banking industry cautioned to be wary of early analysts' attempts to quantify the financial impacts. According to the participant it was not possible to predict the economic and other factors that will exist post 1.1.2018 with any degree of precision and so to be mindful of that challenge. They also noted that firms' IFRS 9 impairment models will be more sensitive to changes in the business cycle, and while they would not predict the financial crisis, they would lead to increased and earlier loan loss reserves than under the current objective evidence based IAS 39 framework.

77 One participant from banking industry commented that a particularly pervasive effect of IFRS 9 may occur for business combinations when loan portfolios acquired are measured at fair value upon acquisition and 12-month expected losses will be recognised in profit or loss for the whole portfolio. Further, the outcome will differ on whether the portfolio is accounted for at amortised cost (with 12-month expected losses recognised) in the banking book or at fair value through profit or loss (no 12-month expected losses recognised).

78 One participant from the insurance industry noted that impairment on assets measured at amortised cost and FVOCI had a linkage with the measurement of certain insurance contract liabilities. Further work was needed to ensure that the requirements of the expected credit loss model did not create any consequences for the valuation of insurance contract liabilities.

79 Regarding regulatory aspects, one participant from the banking industry referred to uncertainty on how the new model is going to work together with regulatory capital. Another participant from the banking industry called for careful interpretations and was worried about the influence of the Basel Committee where regulators (including those from US) could try to move the adoption of IFRS 9 impairment rules near to the FASB model.

80 One participant from the banking industry noted that the validation of the relevant data needed to be done in a couple of days due to very short remittance dates of FINREP data by the banking supervisors, other regulatory reportings and management reporting.

81 One participant form the banking industry noted that the expected loss model required a day-one-loss to be recognised for financial assets measured at amortised cost even though the contract was expected to be profitable. This inconsistency was enhanced by the fact that no day-one loss was expected to be recognised for loan agreements measured using the fair value option, neither was equity be negatively affected for financial assets measured at fair value through OCI since the 12-month-expected loss in profit or loss in those cases will be reversed in OCI. That created clear incentives for entities to classify certain assets (floating rate assets and assets with short contractual durations) at fair value instead of amortised cost.

Part 3: General hedge accounting

Any remaining concerns

Proxy hedging - macro hedging – carve out

82 One participant from the banking industry did not believe that IFRS 9 would bring an alignment of hedge accounting with risk management as long as the hedge accounting requirements of IAS 39 were maintained as an alternative since these were considered as a documentation exercise. Also as banks used internal derivatives in their internal risk management, requiring an alignment with internal risk management would not be feasible.

83 One participant from the insurance industry was concerned whether the designated hedge accounting relationships following the implementation guidance for hedging in IAS 39 paragraphs IG.F were still valid under IFRS 9 since they were not transferred to IFRS 9.

84 One participant from the insurance industry believed that the IASB should amend the paragraphs related to the EU carve out in order to allow for hedge accounting of insurance liabilities. The participant considered that the ability to use hedge accounting principles under IFRS 9 (as well as current IAS 39) would be still be limited for insurance companies because of the restrictions on macro-hedging.

85 One participant from the banking industry was uncertain in which cases the EU carve out could be applied as well as whether macro cash flow hedges could be applied under IFRS 9 or should remain under IAS 39.

Identification of gains or losses of hedged items by nature

86 Few participants from other industries noted that IFRS 9 did not allow to identify and track the effect of gains or losses on hedging instruments by nature of hedged items in case of cash flow hedges that constitute for a net position. One of those participants noted that allocating the impact of hedging instruments gains or losses on different lines of the profit or loss account was more pertinent for users and was developing an IT-tool internally to do so.

Written options

87 Few participants from other industries noted that written options did not qualify as hedging instruments. One of those participants noted that written options were used for hedging generating assets which were economically considered as a call option but were accounted for at historical cost under IAS 16. Written options were considered by the participant as the best hedge of future cash flows of the assets and were widely used by the utility industry.

Insurance risks

88 One participant from the insurance industry believed that inflation risk, even if not contractually specified, should be considered to be separately identifiable and reliably measurable under certain conditions; in the same way hedge accounting for hedges of credit risk using credit derivatives should be permitted to the extent that it was measurable.

89 One participant from the insurance industry noted more guidance was required to clarify the application of hedge accounting of insurance risks under IFRS 9 and noted that this represented a significant progress in reflecting their assets and liabilities management model. Moreover, the participant noted that the business model as defined by IFRS 9 should be more aligned with the business model and practices of insurance companies as practices by the industry should be reviewed.

Net position hedge

90 One participant from other industries noted that hedges of a net position should be allowed for commodity risk, considering that the practical approach to designate a gross position (that is in theory allowed in IFRS 9) was not workable in a dynamic environment where the hedge items can evolve frequently (and not only in response to changes in commodity market prices). The participant welcomed that the IASB was following this issue as part of the macro-hedge accounting framework.

Operational cost relating to hedge accounting

91 One participant from the insurance industry noted they did not apply hedge accounting under IAS 39 because of the high implementation cost. The participant would consider IFRS 9 as an opportunity to more extensively use hedge accounting or the existing carve out of IAS 39.

92 One participant from other industries was concerned about the need to change systems and tools to address the new hedge accounting requirements, in particular regarding rebalancing.

Part 4: Overall assessment of IFRS 9

Notes of participants on endorsement

93 Some participants from the banking industry expressed their opinion on the endorsement of IFRS 9. Some participants from the banking industry called for an endorsement, of those few specified that the process should lead to an early endorsement.

94 Of those participants from the banking industry calling for an endorsement, one participant asked for endorsement under the condition that regulators did not alter the implementation of IFRS 9. None of the participants explicitly called for not endorsing the IFRS 9, however, one participant from the banking industry expressed a strong disagreement with IFRS 9 throughout the questionnaire.

95 One participant from other industries considered to apply IFRS 9 early from 2016 on, in particular to benefit from the general hedge accounting provisions, but added it depended on the endorsement of IFRS 9 beforehand.

Appendix: List of participants in the questionnaire

Participant	Industry
Anonymous	Banking
Anonymous	Banking
Barclays	Banking
BayernLB	Banking
BNP Paribas	Banking
BPCE	Banking
Deutsche Bank	Banking
Handelsbanken	Banking
HSBC	Banking
Lloyds Banking Group	Banking
Oldenburgische Landesbank	Banking
Allianz	Insurance
Assicurazioni Generali	Insurance
AXA	Insurance
CNP	Insurance
Anonymous	Other industries
Continental	Other industries
EDF	Other industries
Energie Baden-Württemberg	Other industries
Henkel	Other industries
L'Oréal	Other industries
Linde	Other industries
Sanofi	Other industries
Vinci	Other industries