IFRS 9 – Financial Instruments

“Road to a successful implementation of the new requirements”
Since the first discussions in 2008, and once again exemplified in the publication of the regulation 'IFRS 9 – Financial Instrument' by the IASB in July 2014, it is clear that the new accounting and valuation rules for financial instruments signify the need for a fundamental change in the banking sector. The new regulations set forth must be implemented by 01/01/2018. This deadline presents significant challenges for the majority of European banks and financial institutions, particularly in functional, procedural, technical, organisational, and strategic areas. Therefore, the implementation of these regulations requires time, professional and technical expertise, a robust transformational plan, as well as a validated approach to cover all dimensions.

The following report contains the business requirements, in particular the strategic, organisational, procedural and functional challenges posed by IFRS 9. This report prioritizes classification, measurement and impairment, particularly concentrating on our proven IFRS transformation approach, as well as the critical success factors which will be essential for the effective implementation of IFRS 9 requirements.
IFRS 9 will replace the requirements for classification and measurement of financial instruments under IAS 39. While some of the IAS 39 requirements can be transferred almost identically into IFRS 9 regulation (for example accounting of financial liabilities, derecognition rules), accounting of financial assets under IFRS 9 will be fundamentally different. This includes the classification and measurement of financial assets, the introduction of a new impairment model and new hedge accounting rules.

**Classification and Measurement**

In future financial statements, the classification and measurement of financial assets will be derived from the allocation of the financial instrument to one of three business models, which will be based on the design of the contractual cash flows.

There are three valuation methods (known from IAS 39) - amortised cost, fair value through other comprehensive income, (FVOCI) and fair value through profit and loss (FVP&L).

A valuation of amortised costs (FVOCI) will only be possible if the contractual cash flow characteristics (CCC-Test) show that these costs cover solely payments of principal and interest (SPPI). Establishing a distinction between ‘recycling’ and ‘without-recycling’ is important when measuring at FVOCI. Recycling means that after derecognition of a financial instrument, a reclassification of the accrued effects in OCI is required in the income statement. A derivation of the measurement categories is highlighted in Figure 1.

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**Figure 1: Derivation of classification/ measurement from the business model und CCC-Test**

**Approach for classification of financial assets according to IFRS 9**

- **Financial Assets**
  - Business Model „Hold“?
  - Business Model „Hold & Sell“?
  - Contractual cash flows are solely principal and interest (CCC-Test positive)?
  - Fair Value Option chosen?
  - Amortised Cost
  - FVOCI (Recycling)

- **Derivatives**
  - Trading intended?
  - Fair Value Option chosen?
  - FVP&L

- **Equity instruments**
  - Trading intended?
  - Fair Value Option chosen?
  - FVOCI (no Recycling)

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1 IFRS 9 regulation for hedge accounting will not be covered in this document as the focus of this report is on classification, measurement and impairment.
Impairment

Depending on the selected business model, a new impairment model may have to be applied. Under IAS 39 only the incurred losses are considered, however, now the new expected loss approach requires the recognition of the expected future losses of each financial instrument. The new impairment model is mandatory for all financial instruments, which should be measured at amortised cost or at fair value through OCI in accordance with IFRS 9.

Contrary to IAS 39 regulation which only requires a distinction between ‘performing’ and ‘non-performing’ defaulted financial instruments, IFRS 9 requires allocations in three stages, according to the credit risk of the transaction. Consequently, financial assets which were previously classified as ‘performing’ must now be distinguished as either having a low or high default risk.

In the future, a loan loss allowance/provision will have to be established for all financial assets to which the new impairment model applies. This means that in comparison to IAS 39, an expected loss should already be predetermined and recorded in the accounts, after the financial instrument is recognized. The IFRS 9 regulation distinguishes between the determination of a ‘12 Month Expected Loss’ (generally at initial recognition and low default risk) and a ‘Lifetime Expected Loss’. For calculation of the loan loss allowances/provisions, the same parameters which have already been used under IAS 39, will predominantly be applied – i.e. default probabilities, expected cash flows, and historical effective interest rates. Additionally, parameters with forward-looking information, particularly macro-economic factors, must be taken into consideration.

The following overview illustrates the three-stage-model including the relevant impairment recognition.

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2 Under IFRS 9 regulations, financial instruments which have suffered a significant deterioration since entry are assigned to stage 2.
Challenges

**Strategy**

**Business Model**

IFRS 9 regulations require financial instruments to be allocated to one of three business models. Depending on the business model that is assigned, the initial and subsequent measurement of financial instruments may vary. As a result, these measurements are reflected differently in the balance sheet and the income statement. Therefore, before implementing IFRS 9, it is essential to analyse the potential consequences of assigning the individual product groups into one of the three business model categories. Assignment changes will only be possible in exceptional cases. The following questions must be answered prior to the assignment of product groups:

- Is the assignment of the product groups in line with the business strategies? Are adjustments to the existing strategies required?
- To which product groups can the classifications according to IAS 39 (held to maturity, held for sale, available for sale, loans and receivables) be applied? Which product groups need new classification and thus a different valuation methodology?
- What (if any) impacts will the business model assignment have on the business plan (short, medium, and long term)?
- What impact will IFRS 9 have on the key performance indicators (particularly risk management)? Are the current company balance sheet and P&L control mechanisms still sustainable?

**Impairment Model**

The new expected loss approach for measuring impairments will have a significant impact on performance indicators, which means that financial institutions and companies should perform indicative scenario and simulation calculations early on in order to foresee potential consequences and modify the performance indicators (incl. budget figures) accordingly. A solid methodology for defining and handling the three different classification levels is essential. It is important to establish the impairment models based on common data sets. When defining an appropriate impairment model, the following key issues, amongst others, may arise:

- How will the IFRS 9 criteria be defined for the classification of Stage 2 ‘significantly deteriorated’ and Stage 3 ‘defaulted’ in accordance with other regulations (e.g. EBA, forbearance, CRR)?
- Can the current impairment models (individual vs. portfolio-based approach) still be used or adjusted to meet the IFRS 9 requirements? Should a new impairment engine be established?
- How should forward-looking information (e.g. macroeconomic factors) in impairment models be taken into account? How should the regular validation process be performed?
- Which macroeconomic factors will impact the business segments? Who provides reliable forecasting data for selected factors?
- How is data availability and how is the quality regarding the new impairment models ensured?

**Organisation**

Strategic changes typically require organisational re-designs. As such, it is beneficial to critically analyse the organisational structure while implementing IFRS 9.

- Is the current organisational structure still appropriate? Are any adjustments required?
- Which areas/ departments/ teams are affected by the implementation of IFRS 9? Will the affected groups be sufficiently informed about the changes and consequences, and adequately integrated into the implementation project?
- How are prospective roles and responsibilities structured within the line operation? Is appropriate expertise available? In which areas is training needed?
- How can a group-wide implementation of IFRS 9 inclusive of all branches and subsidiaries in compliance with the group’s accounting policies be ensured? How will the cooperation with these entities take place?

The appropriate cooperation between major projects and line organisations poses a significant challenge for institutes and companies, especially considering that the line organisation usually has limited resources. Nevertheless, the line organisations must provide substantial technical input and support. It is important to keep the line organisations informed in the early stages of the project initiation in order to ensure their support/ commitment to the project. The necessary cooperation between risk and finance on the IFRS 9
The project presents a unique challenge, since these areas have different focuses, separated process sequences, and different approaches. In addition, cultural differences in these areas have to be taken into account.

**Processes and architecture**

The introduction of IFRS 9 to financial instruments does not only pose significant challenges to the organisational structure, but also to the operational structure. The new requirements for the accounting and impairment models must be mapped and implemented systematically and procedurally.

Firstly, it must be determined whether the new functional requirements can be implemented within the existing functional infrastructure. If not, the existing system components will need additions or replacements by new systems or applications (e.g. SAP-BA-AFI). In regard to the existing IT systems and processes, the following questions arise:

- **At which process stage should a classification of financial instruments take place (e.g. front office)?**
- **Can the systems be adapted such that a classification decision is possible? Can a precise and coherent documentation (justification of classification decision) be ensured?**
- **How do verifications/validations of these classification decisions take place (establishment of fixed automated validation rules)?**
- **Can the existing valuation architecture approach fulfill the 3-stage expected loss model? Is it necessary to introduce a new model/system (i.e. impairment engine)?**
- **Should new processes be defined and established (allocation of financial instruments to the different stages in the expected loss model)? Are these new processes performed automatically or manually?**

**Data availability and quality**

The availability of high quality data is essential to the implementation of IFRS 9, especially with regard to the allocation of impairment calculations to the different stages. In order to assess the change in credit quality and to calculate the impairment, it is important to track and archive transaction data. Thus, it must be ensured (for the initial application) that a 12 month expected loss can be calculated on the basis of historical data. In addition, the new expected loss models require new attributes and features (macroeconomic factors), which must be generated or made available by the respective systems. As a result, a major challenge is that existing source systems can often only be expanded with significant effort.

New systems are also associated with high costs. In practice, time-consuming data reconciliations usually have to be performed manually to ensure the required quality and validity of these models are met.

In order to adequately address the quality and availability of data required for the project, sufficient **simulations and quality gates** must be installed. Data delivery must meet a minimum quality standard in regard to the different requirements such as data quality tests and the analyses of the balance sheet and income statement. For instance, if there is insufficient information to allocate a transaction to the Stage 1 impairment phase, this transaction has to be allocated to Stage 2 – which means that poor data quality leads to higher loan loss allowances.

Extensive analyses (especially data in source systems) are usually required in order to avoid dirty data as well as to help identify and solve any problems that may arise.

**Internal and external reporting**

Disclosure requirements under IFRS 9 for internal and external reporting vary. Existing systems, processes and interfaces (for internal and external reporting) should be adapted, with a particular focus on disclosures, in order to meet the requirements and to provide the mandatory information for reporting purposes. For instance, a list of unavailable data should be compiled if the unavailability is a result of restructured contracts, modified model parameters or movers between the three stages. With these issues in mind, the company should be aware of following challenges:

**External reporting**

- **What information must be disclosed in the financial reports? What information is already available within the company in the different systems?**
- **How does one deal with unavailable data? Can it be collected without much effort? What consequences may arise due to missing data?**
- **How will IFRS 9 requirements and its initial application in the notes be displayed?**
- **When will required data be available? Are account closing plans and respective publications endangered?**
Internal reporting

- What information does the top management need to make decisions?
- Is the internal reporting in line with the strategic direction of the company after reworking the business models with regard to IFRS 9?
- How many internal reports are affected by the changes/improvements? Who is responsible for making the necessary adjustments?

Additionally, in order to ensure the proper recognition and valuation of financial assets under IFRS 9, the following tasks have to be addressed:

- Impact on chart of account: Under IFRS 9, a content-related reallocation of financial instruments to accounts and categories must be made – the same applies for the conception of impairments. New accounts have to be opened and/or existing accounts have to be recorded. The conflict between a central solution and a local chart of accounts is a particular challenge.

- Adaptation of accounting procedures: New booking procedures in accounting must be defined for both impairment and for the re-categorisation of financial instruments.

- Expansion of internal policies: New rules for accounting and measurement of financial instruments (under IFRS 9) must be incorporated into the group guidelines (e.g. handling of non-performing loans (Stage 3) and group accounting policies).

1 Data availability is also a procedural challenge in particular...
Capgemini Consulting, the global strategy and transformation consulting brand of Capgemini Group, has extensive experience, best practices and validated process methodologies to support customers with the implementation of IFRS 9. The process model that Capgemini Consulting has developed is divided into four phases.

**Phase approach**

- **Scope & Analysis Phase** – The objective here is to gain a clear understanding of customer structures. The focus is on the as-is analysis i.e. the understanding of the business model, organisation, processes and architecture. Gap analyses and simulations/conception scenarios are also conducted. The analyses help identify the potential impact of IFRS 9 on the aforementioned areas, as well as help define measures and recognize areas where action must be taken. In the initial phase, the development of an Architecture Blueprint is essential as it defines the architectural framework and sets up “Principles” for the project. The framework will be validated and adjusted during the project if necessary, depending on the applicability.

- **Design Phase** – The design phase defines the target picture of IFRS 9 for risk and financial functions, the development of a transformation strategy and the definition of detailed business requirements, i.e. the expected loss models, booking procedures, architectural components, processes, organisation and the necessary data management. In addition, applicable test concepts are developed in order to consider the needs in the design phase by using cases from the test perspective. This phase is essential in the project lifecycle to ensure that all requirements in the functional or technical concepts are included and fully validated before the implementation phase starts. Above all, the most essential part of the design phase is the involvement of the line organization.

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**Figure 3: Which is the way to go in order to master the challenges?**

<table>
<thead>
<tr>
<th>Phase 1 – Scope &amp; Analysis</th>
<th>Phase 2 – Design</th>
<th>Phase 3 – Implementation</th>
<th>Phase 4 – Reporting</th>
</tr>
</thead>
<tbody>
<tr>
<td>Collect top management’s finance and risk vision and ideas to define goals, scope and assumptions.</td>
<td>Identification and classification of different project tasks.</td>
<td>Implementation of necessary IT service components and IT architecture.</td>
<td>Improvement of IFRS 9 processes.</td>
</tr>
<tr>
<td>Analyses of as-is situation.</td>
<td>Close alignment with all involved departments.</td>
<td>Development of calculation models.</td>
<td>Model adjustments.</td>
</tr>
<tr>
<td>Classification criteria.</td>
<td>Development of change management strategy.</td>
<td>Integration of data storage solutions, data streams and process workflows.</td>
<td>Optimisation of data availability and data quality.</td>
</tr>
<tr>
<td>Existing IT infrastructure, systems and data sources.</td>
<td>Creation of test concepts.</td>
<td></td>
<td>(Optional: Parallel reporting).</td>
</tr>
<tr>
<td>Development of simulation tools, data sets and scenarios.</td>
<td></td>
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<tr>
<td>Creation of blueprint with high-level target image that is validated during the project.</td>
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<tr>
<td>Data modeling.</td>
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<td>Process design.</td>
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<td>Roles &amp; Responsibilities.</td>
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<td>Creation of test concepts.</td>
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</tbody>
</table>

1-3 Months 3-8 Months 8-12 Months
and to ensure that they understand the specific needs and can validate the design. Within the design phase, it is fundamental to ensure the quality of data in order to avoid too many manual alignments and to ensure that a solution with a stable process is found.

- **Implementation Phase** – The implementation phase focuses on the execution of the target picture, including the architecture components and applications such as IFRS 9 calculation engines. These calculations consist of new booking procedures, adjustments of the data models or reports, as well as other processes (such as new reconciliation processes for ensuring a high quality of data). Necessary changes in the organisational and financial structure can then proceed once the other processes are completed. This includes e.g. the involvement of line managers during the implementation phase in order to obtain the practical test early on. Another integral part of the implementation phase is the collaboration of relevant departments throughout the testing phase to ensure the usability of IT developments and the accuracy of the implementation.

- **Reporting Phase** – In order to adequately prepare for going live, optimisation possibilities will be developed in the last phase, i.e. adjustments in methods or analyses will be performed in order to explain or validate any discrepancies. If necessary, adjustments to the organisational and governance functions will be made at this time.

Capgemini Consulting also offers optional post going live support, helping companies tackle problem areas that could have occurred throughout the implementation phase or in low-priority areas. In this phase Capgemini Consulting will provide continuous improvement approaches.

**Parallel phase as option for 2017**

An optional approach for the implementation is known as the ‘Parallel Run’. Here, Capgemini Consulting supports the implementation of processes and aligns the applicable development models. Consequently, it is essential to quickly identify additional tasks that must be accomplished, such as the validation of the IFRS 9 results, or the stabilisation of the new processes. Since the regulators do not necessarily require a ‘Parallel Run’, it can be considered an optional component in the implementation planning. However, financial institutions and companies that decide to execute a ‘Parallel Run’ must be aware that the IFRS 9 solution has to be set up by the beginning of 2017.

**Critical success factors for an IFRS 9 project**

**Holistic and need-based project approach**

The chosen project approach will play an important role because a holistic implementation approach is necessary in order to cover the individual needs and requirements of customers. In order to derive and prioritise the individual areas of action, a comprehensive analysis of the organisation, the system architecture, and the processes, has to be performed. For this reason, it is advisable to compile a blueprint in the beginning to analyse the processes and architecture components affected by IFRS 9. Based on the aforementioned analysis results, suitable project governance with corresponding project work streams should be defined in order to meet all organisational, functional and technical requirements. A clear definition of organisational structures, roles and responsibilities is required. Management must also remember that subsidiaries and branches will need assistance from the parent company in order to meet IFRS 9 regulations locally.

**Harmonisation of finance and risk**

For the implementation of IFRS 9, it is essential that finance and risk work together towards a joint goal. The focus of the harmonisation should be on:

- the **joint usage of data** for calculation of ‘expected loss’ as well as the associated impairment bookings
- the **harmonisation of time schedules** for the creation of risk and financial reports
- highlighting **process dependencies** between finance and risk and merging these processes
- an efficient organisational set-up that satisfies the harmonised process
Efficient project and change management

In order to ensure a successful project implementation, an efficient Project Management Office (PMO) has to be established. The PMO is responsible for the definition and implementation of comprehensive unified reporting and project processes (standard reporting, meeting framework, staffing process, risk register, and administrative checks).

A central change management team supports and coordinates the project communication within the company and ensures that there is adequate stakeholder management, particularly at the top management level, in order to ensure the ongoing support and agreement at all hierarchical levels. A structured communication, separation and integration of potentially competing projects (e.g., BCBS 239, AnaCredit) can generate additional synergy effects.

However, the main responsibility of the change management team is to ensure the efficient and transparent handover of project activities to the line organisation. Early on it is recommended that regular meetings (e.g., brown bag sessions, communication forums, newsletters) take place, where employees outside the project can be informed on project topics and statuses. With the help of a training concept adjusted for the line organisation, professional, procedural and technical changes can be transferred into the business organisation.

Robust system architecture

Each institution must define an efficient system architecture for the IFRS 9 solution based on the system architecture that adapts best to the existing infrastructure. When selecting systems and applications, important decisions need to be made regarding compatibility, adaptability and local or centralised implementation. Here, IFRS 9 should represent an additional component of an integrated finance and risk architecture. An integrated finance and risk architecture enables the centralisation of the major functionalities.

Profound business impact analysis

A profound and early ascertainment of the quantitative effects of IFRS 9 on the company’s performance indicators and financials is essential in order to take strategic measures (e.g., corporate strategy, product line) early on and to sustainably align the business plan accordingly. Besides long-term expected changes, a business impact analysis should definitely include the ascertainment of initial adoption effects, which must be disclosed and explained in detail in the external report.

Figure 4: Exemplary central IFRS solution incl. functional overview

![Diagram showing exemplary central IFRS solution with functional overview.](image-url)
Early involvement of locations

Among global financial institutions or companies, it is essential to involve the locations early on, so that the country-specific requirements are understood and included in the solution making process. This is especially important for a centralised solution for IFRS. In order to take resulting complexity into account, sufficient time for coordination between the different locations must be planned throughout the design and implementation phase.

Appropriate data management, data governance and data quality

A suitable data management with uniform functional language, appropriate data quality and data governance has to be built. Companies are encouraged to hire a Quality Gatekeeper who will be solely responsible for the fulfilment of data standards and maintaining the quality of data.

The Quality Gatekeeper should also ensure the uniform treatment of different data standards. In financial institutions, it is not unusual that different data standards are used in finance and risk functions.

In addition, the quality gatekeeper has to ensure that the quality of the data meets the standards of the IFRS 9 solution definition. This means that the quality gatekeeper has to ensure that data validation receives technical support throughout the entire process, so that the significance of numbers is improved and costly manual alignment is not required. Taking these steps can drastically reduce the error rate and manual work steps.

Profound test management

In order to ensure a smooth execution of the testing phase and due to the large number of required system-based adjustments, efficient test management should be set up early on. These include i.e. conception of test plans, definition of test principles, selection of appropriate testing tools for documentation purposes, definition of test environments, creation of test frameworks as well as test case definitions etc. – thus, a test management should already be set up and involved in the design phase.

Transformation manager

In large companies, the establishment of ‘transformation managers’ is recommended, as these managers represent the link between the project and the line organisation. This role is usually performed by representatives from the departments that participate in regular meetings, maintain the flow of information in both directions, communicate project requirements and ensure the subsequent implementation in the line.

Early involvement of the auditor

Early and ongoing involvement of a corresponding auditor should be established in order to discuss and prevent possible consequences for non-compliance/deviations from the IFRS 9. This ensures that the design does not lead to serious issues during the annual audit procedure.
Why Capgemini Consulting?

Together with our clients we develop an individual and efficient project approach, which accounts for the needs and characteristics of our clients. For this purpose we draw on our long-term expertise, international experience, latest trends and best practices from the banking and industry sector. With the support of our colleagues from Capgemini Application Services and our subsidiary Sogeti, we can provide a comprehensive project team comprising technical, process and project management experts combined with IT implementation and testing experts. Thus, we offer a holistic transformation approach from a single source that covers the project setup right up to go-live support of all phases in a project.
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