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Impact of IFRS 9
Financial Instruments

About this supplement

This supplement has been produced by the KPMG International Standards Group (part of KPMG IFRG Limited) and should be read in conjunction with our Guide to annual financial statements – Illustrative disclosures for banks (IAS 39) for December 2016 year ends.

The December 2016 guide helps banks prepare financial statements in accordance with IFRS, illustrating one possible format for financial statements based on a fictitious banking group (the Group); the Group is not a first-time adopter of IFRS.

This supplement is intended to help banks prepare IFRS 9-related pre-transition disclosures as required by IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors for standards that have been issued but are not yet effective in their 2017 financial statements. It comprises Note 45 ‘Standards issued but not yet effective’, which has been updated since the December 2016 guide and illustrates what the IFRS 9-related pre-transition disclosures may look like in a bank’s 2017 financial statements.

Users and regulators are showing an increasing interest in understanding the possible impact that the adoption of IFRS 9 will have on the financial statements of banks. As a consequence, significant focus is expected on the pre-transition disclosures.

Regulators have communicated their expectation that, as preparations for implementation progress, more information about the possible impact that the adoption of IFRS 9 will have on the financial statements should become known or reasonably estimable, and preparers should therefore be able to provide progressively more entity-specific qualitative and quantitative information. In particular, in preparing IFRS 9-related pre-transition disclosures, banks should consider:

- the specific considerations set out in the Public Statement of European Common Enforcement Priorities issued by the European Securities and Markets Authority (ESMA) on 27 October 2017;
- the guidance in the Statement on Implementation of New Accounting Standards issued by the International Organization of Securities Commissions (IOSCO) on 15 December 2016; and
- the recommendations made by the Enhanced Disclosure Task Force (EDTF) in its Impact of Expected Credit Loss Approaches on Bank Risk Disclosures, issued on 7 December 2015.

The disclosures illustrated in this supplement assume that the Group has substantially finalised its pre-transition work and is at an advanced stage in its implementation of IFRS 9. Accordingly, it is able to provide the qualitative and quantitative disclosures illustrated. However, the status of IFRS 9 implementation will vary between entities and, as a result, the nature of disclosures that each entity is able to provide in its December 2017 financial statements will also vary. The disclosures provided under IAS 8 will depend on what information is available, the reliability of that information and the significance of its impact on the financial statements.

The nature and extent of pre-transition disclosures may require significant management judgement to determine what information is relevant to assessing the potential impact of applying IFRS 9. Accordingly, the disclosures in this supplement are only an illustrative example of one possible scenario and more or less disclosure may be appropriate, depending on the entity’s circumstances.

This supplement does not illustrate the IAS 8 pre-transition disclosures for standards other than IFRS 9 that have been issued but are not yet effective.

IFRS and its interpretation change over time. Accordingly, this supplement should not be used as a substitute for referring to the standards and other relevant interpretative guidance.
References and abbreviations

References to the standards are included in the left-hand margin of this supplement to identify the source of the related disclosure requirements.

The following abbreviations are used often in this supplement.

- **ECL**  Expected credit loss
- **FVOCI** Fair value through other comprehensive income
- **FVTPL** Fair value through profit or loss
- **IRB** Internal ratings based
- **OCI** Other comprehensive income
45. Standards issued but not yet effective

A number of new standards are effective for annual periods beginning after 1 January 2017 and earlier application is permitted; however, the Group has not early adopted the new standards in preparing these consolidated financial statements.

The following standards are expected to have a material impact on the Group's financial statements in the period of initial application.

IFRS 9 Financial Instruments

In July 2014, the IASB issued the final version of IFRS 9 Financial Instruments. IFRS 9 is effective for annual periods beginning on or after 1 January 2018, with early adoption permitted. It replaces IAS 39 Financial Instruments: Recognition and Measurement.

In October 2017, the IASB issued Prepayment Features with Negative Compensation (Amendments to IFRS 9). The amendments are effective for annual periods beginning on or after 1 January 2019, with early adoption permitted.

The Group will apply IFRS 9 as issued in July 2014 initially on 1 January 2018 and will early adopt the amendments to IFRS 9 on the same date. Based on assessments undertaken to date, the total estimated adjustment (net of tax) of the adoption of IFRS 9 on the opening balance of the Group’s equity at 1 January 2018 is approximately €500 million, representing:

– a reduction of approximately €700 million related to impairment requirements (see (ii));
– a reduction of approximately €50 million related to classification and measurement requirements, other than impairment (see (i) and (iii)); and
– an increase of approximately €250 million related to deferred tax impacts.

The above assessment is preliminary because not all transition work has been finalised. The actual impact of adopting IFRS 9 on 1 January 2018 may change because:

– IFRS 9 will require the Group to revise its accounting processes and internal controls and these changes are not yet complete;
– although parallel runs were carried out in the second half of 2017, the new systems and associated controls in place have not been operational for a more extended period;
– the Group has not finalised the testing and assessment of controls over its new IT systems and changes to its governance framework;
– the Group is refining and finalising its models for ECL calculations; and
– the new accounting policies, assumptions, judgements and estimation techniques employed are subject to change until the Group finalises its first financial statements that include the date of initial application.

a. The Group has disclosed known or reasonably estimable information relevant to assessing the possible impact that the application of IFRS 9 will have on its financial statements in the period of initial application that was available when the financial statements were prepared. Some regulators have indicated that they expect the extent of quantitative disclosures to increase as the mandatory effective date of a new standard approaches.

b. The Group has not early adopted IFRS 9 in its consolidated financial statements for the year ended 31 December 2017. Our Guide to annual financial statements: IFRS 9 – Illustrative disclosures for banks (March 2016) provides disclosure examples and explanations on early adoption of IFRS 9.
Notes to the consolidated financial statements (continued)

45. Standards issued but not yet effective (continued)
IFRS 9 Financial Instruments (continued)

i. Classification – Financial assets

IFRS 9 contains a new classification and measurement approach for financial assets that reflects the business model in which assets are managed and their cash flow characteristics.

IFRS 9 includes three principal classification categories for financial assets: measured at amortised cost, FVOCI and FVTPL. It eliminates the existing IAS 39 categories of held to maturity, loans and receivables and available for sale.

A financial asset is measured at amortised cost if it meets both of the following conditions and is not designated as at FVTPL:

- it is held within a business model whose objective is to hold assets to collect contractual cash flows; and
- its contractual terms give rise on specified dates to cash flows that are solely payments of principal and interest (SPPI) on the principal amount outstanding.

A financial asset is measured at FVOCI only if it meets both of the following conditions and is not designated as at FVTPL:

- it is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets; and
- its contractual terms give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

On initial recognition of an equity investment that is not held for trading, the Group may irrevocably elect to present subsequent changes in fair value in OCI. This election is made on an investment-by-investment basis.

All financial assets not classified as measured at amortised cost or FVOCI as described above are measured at FVTPL. In addition, on initial recognition the Group may irrevocably designate a financial asset that otherwise meets the requirements to be measured at amortised cost or at FVOCI as at FVTPL if doing so eliminates or significantly reduces an accounting mismatch that would otherwise arise.

A financial asset is classified into one of these categories on initial recognition. See (viii) for the transition requirements relating to classification of financial assets.

Under IFRS 9, derivatives embedded in contracts where the host is a financial asset in the scope of IFRS 9 are not separated. Instead, the hybrid financial instrument as a whole is assessed for classification.
Notes to the consolidated financial statements (continued)

45. Standards issued but not yet effective (continued)

IFRS 9 Financial Instruments (continued)

i. Classification – Financial assets (continued)

Business model assessment

The Group will make an assessment of the objective of the business model in which a financial asset is held at a portfolio level because this best reflects the way the business is managed and information is provided to management. The information that will be considered includes:

- the stated policies and objectives for the portfolio and the operation of those policies in practice, including whether management’s strategy focuses on earning contractual interest revenue, maintaining a particular interest rate profile, matching the duration of the financial assets to the duration of the liabilities that are funding those assets or realising cash flows through the sale of assets;
- how the performance of the portfolio is evaluated and reported to the Group’s management;
- the risks that affect the performance of the business model (and the financial assets held within that business model) and how those risks are managed;
- how managers of the business are compensated – e.g. whether compensation is based on the fair value of the assets managed or the contractual cash flows collected; and
- the frequency, volume and timing of sales in prior periods, the reasons for such sales and expectations about future sales activity. However, information about sales activity is not considered in isolation, but as part of an overall assessment of how the Group’s stated objective for managing the financial assets is achieved and how cash flows are realised.

Financial assets that are held for trading and those that are managed and whose performance is evaluated on a fair value basis will be measured at FVTPL because they are neither held to collect contractual cash flows nor held both to collect contractual cash flows and to sell financial assets.

The objective of the entity’s business model is not based on management’s intentions with respect to an individual instrument, but rather is determined at a higher level of aggregation. The assessment needs to reflect the way that an entity manages its business or businesses. A single reporting entity may have more than one business model for managing its financial instruments.
Notes to the consolidated financial statements (continued)

45. Standards issued but not yet effective (continued)

IFRS 9 Financial Instruments (continued)

i. Classification – Financial assets (continued)

Assessment whether contractual cash flows are solely payments of principal and interest

For the purposes of this assessment, ‘principal’ is defined as the fair value of the financial asset on initial recognition. ‘Interest’ is defined as consideration for the time value of money, for the credit risk associated with the principal amount outstanding during a particular period of time and for other basic lending risks and costs (e.g. liquidity risk and administrative costs), as well as a profit margin.

In assessing whether the contractual cash flows are solely payments of principal and interest, the Group will consider the contractual terms of the instrument. This will include assessing whether the financial asset contains a contractual term that could change the timing or amount of contractual cash flows such that it would not meet this condition. In making the assessment, the Group will consider:

– contingent events that would change the amount and timing of cash flows;
– leverage features;
– prepayment and extension terms;
– terms that limit the Group’s claim to cash flows from specified assets – e.g. non-recourse asset arrangements; and
– features that modify consideration for the time value of money – e.g. periodic reset of interest rates.

Interest rates on certain retail loans made by the Group are based on standard variable rates (SVRs) that are set at the discretion of the Group. SVRs are generally based on a central bank rate in a particular jurisdiction and also include a discretionary spread. In these cases, the Group will assess whether the discretionary feature is consistent with the SPPI criterion by considering a number of factors, including whether:

– the borrowers are able to prepay the loans without significant penalties;
– the market competition ensures that interest rates are consistent between banks; and
– any regulatory or customer protection framework is in place that requires banks to treat customers fairly.

All of the Group’s retail loans and certain fixed-rate corporate loans contain prepayment features.

A prepayment feature is consistent with the SPPI criterion if the prepayment amount substantially represents unpaid amounts of principal and interest on the principal amount outstanding, which may include reasonable compensation for early termination of the contract.

In addition, a prepayment feature is treated as consistent with this criterion if a financial asset is acquired or originated at a premium or discount to its contractual par amount, the prepayment amount substantially represents the contractual par amount plus accrued (but unpaid) contractual interest (which may also include reasonable compensation for early termination), and the fair value of the prepayment feature is insignificant on initial recognition.
Notes to the consolidated financial statements (continued)

45. Standards issued but not yet effective (continued)

IFRS 9 Financial Instruments (continued)

i. Classification – Financial assets (continued)

Impact assessment

The standard will affect the classification and measurement of financial assets held as at 1 January 2018 as follows.

– Trading assets and derivative assets held for risk management, which are classified as held-for-trading and measured at FVTPL under IAS 39, will also be measured at FVTPL under IFRS 9.

– Loans and advances to banks and to customers that are classified as loans and receivables and measured at amortised cost under IAS 39 will in general also be measured at amortised cost under IFRS 9.

– Held-to-maturity investment securities measured at amortised cost under IAS 39 will in general also be measured at amortised cost under IFRS 9.

– Debt investment securities that are classified as available-for-sale under IAS 39 may, under IFRS 9, be measured at amortised cost, FVOCI or FVTPL, depending on the particular circumstances.

– Loans and advances to customers and investment securities that are designated as at FVTPL under IAS 39 will in general continue to be measured at FVTPL under IFRS 9.

– The majority of the equity investment securities that are classified as available-for-sale under IAS 39 will be measured at FVTPL under IFRS 9. However, some of these equity investment securities are held for long-term strategic purposes and will be designated as at FVOCI on 1 January 2018.

The Group has estimated that, on the adoption of IFRS 9 at 1 January 2018, the impact of these changes (before tax) is a reduction in the Group’s equity of approximately €50 million.

ii. Impairment – Financial assets, loan commitments and financial guarantee contracts

IFRS 9 replaces the ‘incurred loss’ model in IAS 39 with a forward-looking ‘expected credit loss’ model. This will require considerable judgement over how changes in economic factors affect ECLs, which will be determined on a probability-weighted basis.

The new impairment model applies to the following financial instruments that are not measured at FVTPL:

– financial assets that are debt instruments;

– lease receivables; and

– loan commitments and financial guarantee contracts issued (previously, impairment was measured under IAS 37 Provisions, Contingent Liabilities and Contingent Assets).

Under IFRS 9, no impairment loss is recognised on equity investments.

IFRS 9 requires a loss allowance to be recognised at an amount equal to either 12-month ECLs or lifetime ECLs. Lifetime ECLs are the ECLs that result from all possible default events over the expected life of a financial instrument, whereas 12-month ECLs are the portion of ECLs that result from default events that are possible within the 12 months after the reporting date.

The Group will recognise loss allowances at an amount equal to lifetime ECLs, except in the following cases, for which the amount recognised will be 12-month ECLs:

– debt investment securities that are determined to have low credit risk at the reporting date. The Group considers a debt security to have low credit risk when its credit risk rating is equivalent to the globally understood definition of ‘investment-grade’; and

– other financial instruments (other than lease receivables) for which credit risk has not increased significantly since initial recognition.
### Notes to the consolidated financial statements (continued)

#### 45. Standards issued but not yet effective (continued)

**IFRS 9 Financial Instruments (continued)**

**ii. Impairment – Financial assets, loan commitments and financial guarantee contracts (continued)**

Loss allowances for lease receivables will always be measured at an amount equal to lifetime ECLs.

The impairment requirements of IFRS 9 are complex and require management judgements, estimates and assumptions, particularly in the following areas, which are discussed in detail below:

- assessing whether the credit risk of an instrument has increased significantly since initial recognition; and
- incorporating forward-looking information into the measurement of ECLs.

**Measurement of ECLs**

ECLs are a probability-weighted estimate of credit losses and will be measured as follows:

- **financial assets that are not credit-impaired at the reporting date:** the present value of all cash shortfalls – i.e. the difference between the cash flows due to the entity in accordance with the contract and the cash flows that the Group expects to receive;
- **financial assets that are credit-impaired at the reporting date:** the difference between the gross carrying amount and the present value of estimated future cash flows;
- **undrawn loan commitments:** the present value of the difference between the contractual cash flows that are due to the Group if the commitment is drawn down and the cash flows that the Group expects to receive; and
- **financial guarantee contracts:** the present value of the expected payments to reimburse the holder less any amounts that the Group expects to recover.

Financial assets that are credit-impaired are defined by IFRS 9 in a similar way to financial assets that are impaired under IAS 39 (see Note xx).

**Definition of default**

Under IFRS 9, the Group will consider a financial asset to be in default when:

- the borrower is unlikely to pay its credit obligations to the Group in full, without recourse by the Group to actions such as realising security (if any is held); or
- the borrower is more than 90 days past due on any material credit obligation to the Group. Overdrafts are considered past due once the customer has breached an advised limit or been advised of a limit that is smaller than the current amount outstanding.

This definition is largely consistent with the definition that will be used for regulatory purposes (see Note xx).

In assessing whether a borrower is in default, the Group will consider indicators that are:

- qualitative: e.g. breaches of covenant;
- quantitative: e.g. overdue status and non-payment of another obligation of the same issuer to the Group; and
- based on data developed internally and obtained from external sources.

Inputs into the assessment of whether a financial instrument is in default and their significance may vary over time to reflect changes in circumstances.
45. Standards issued but not yet effective (continued)

IFRS 9 Financial Instruments (continued)

ii. Impairment – Financial assets, loan commitments and financial guarantee contracts (continued)

Significant increase in credit risk

Under IFRS 9, when determining whether the credit risk (i.e. risk of default) on a financial instrument has increased significantly since initial recognition, the Group will consider reasonable and supportable information that is relevant and available without undue cost or effort, including both quantitative and qualitative information and analysis based on the Group's historical experience, expert credit assessment and forward-looking information.

The Group will primarily identify whether a significant increase in credit risk has occurred for an exposure by comparing:

- the remaining lifetime probability of default (PD) as at the reporting date; with
- the remaining lifetime PD for this point in time that was estimated on initial recognition of the exposure.

Assessing whether credit risk has increased significantly since initial recognition of a financial instrument requires identifying the date of initial recognition of the instrument. For certain revolving facilities (e.g. credit cards and overdrafts), the date when the facility was first entered into could be a long time ago. Modifying the contractual terms of a financial instrument may also affect this assessment, which is discussed below.

Credit risk grades

The Group will allocate each exposure to a credit risk grade based on a variety of data that is determined to be predictive of the risk of default and applying experienced credit judgement. The Group will use these grades in identifying significant increases in credit risk under IFRS 9. Credit risk grades are defined using qualitative and quantitative factors that are indicative of the risk of default. These factors may vary depending on the nature of the exposure and the type of borrower.

Credit risk grades are defined and calibrated such that the risk of default occurring increases exponentially as the credit risk deteriorates – e.g. the difference in the risk of default between credit risk grades 1 and 2 is smaller than the difference between credit risk grades 2 and 3.

Each exposure will be allocated to a credit risk grade on initial recognition based on available information about the borrower. Exposures will be subject to ongoing monitoring, which may result in an exposure being moved to a different credit risk grade.

Generating the term structure of PD

Credit risk grades will be a primary input into the determination of the term structure of PD for exposures. The Group will collect performance and default information about its credit risk exposures analysed by jurisdiction, by type of product and borrower and by credit risk grading. For some portfolios, information purchased from external credit reference agencies may also be used.

The Group will employ statistical models to analyse the data collected and generate estimates of the remaining lifetime PD of exposures and how these are expected to change as a result of the passage of time.

This analysis will include the identification and calibration of relationships between changes in default rates and changes in key macro-economic factors, as well as in-depth analysis of the impact of certain other factors (e.g. forbearance experience) on the risk of default. For most exposures, key macro-economic indicators are likely to include GDP growth, benchmark interest rates and unemployment.

For exposures to specific industries and/or regions, the analysis may extend to relevant commodity and/or real estate prices.

The Group's approach to incorporating forward-looking information into this assessment is discussed below.
Determining whether credit risk has increased significantly

The Group has established a framework that incorporates both quantitative and qualitative information to determine whether the credit risk on a particular financial instrument has increased significantly since initial recognition. The framework aligns with the Group's internal credit risk management process. The criteria for determining whether credit risk has increased significantly will vary by portfolio and will include a backstop based on delinquency.

The Group will deem the credit risk of a particular exposure to have increased significantly since initial recognition if, based on the Group's quantitative modelling, the remaining lifetime PD is determined to have increased by more than xx% (subject to a minimum increase in PD of xx basis points per annum) since initial recognition. In measuring increases in credit risk, remaining lifetime ECLs are adjusted for changes in maturity.

In certain instances, using its expert credit judgement and, where possible, relevant historical experience, the Group may determine that an exposure has undergone a significant increase in credit risk if particular qualitative factors indicate so and those indicators may not be fully captured by its quantitative analysis on a timely basis. As a backstop, and as required by IFRS 9, the Group will presumptively consider that a significant increase in credit risk occurs no later than when an asset is more than 30 days past due. The Group will determine days past due by counting the number of days since the earliest elapsed due date in respect of which full payment has not been received.

The Group will monitor the effectiveness of the criteria used to identify significant increases in credit risk by regular reviews to confirm that:

- the criteria are capable of identifying significant increases in credit risk before an exposure is in default;
- the criteria do not align with the point in time when an asset becomes 30 days past due;
- the average time between the identification of a significant increase in credit risk and default appears reasonable;
- exposures are not generally transferred directly from 12-month ECL measurement to credit-impaired; and
- there is no unwarranted volatility in loss allowance from transfers between 12-month ECL and lifetime ECL measurements.

**Modified financial assets**

The contractual terms of a loan may be modified for a number of reasons, including changing market conditions, customer retention and other factors not related to a current or potential credit deterioration of the customer. An existing loan whose terms have been modified may be derecognised and the renegotiated loan recognised as a new loan at fair value.

Under IFRS 9, when the terms of a financial asset are modified and the modification does not result in derecognition, the determination of whether the asset's credit risk has increased significantly reflects comparison of:

- the remaining lifetime PD at the reporting date based on the modified terms; with
- the remaining lifetime PD estimated based on data on initial recognition and the original contractual terms.
45. Standards issued but not yet effective (continued)

IFRS 9 Financial Instruments (continued)

ii. Impairment – Financial assets, loan commitments and financial guarantee contracts (continued)

Modified financial assets (continued)

The Group renegotiates loans to customers in financial difficulties (referred to as ‘forbearance activities’) to maximise collection opportunities and minimise the risk of default. Under the Group’s forbearance policy, loan forbearance is granted on a selective basis if the debtor is currently in default on its debt or if there is a high risk of default, there is evidence that the debtor made all reasonable efforts to pay under the original contractual terms and the debtor is expected to be able to meet the revised terms.

The revised terms usually include extending the maturity, changing the timing of interest payments and amending the terms of loan covenants. Both retail and corporate loans are subject to the forbearance policy. The Group Credit Committee regularly reviews reports on forbearance activities.

For financial assets modified as part of the Group’s forbearance policy (see Note xx), the estimate of PD will reflect whether the modification has improved or restored the Group’s ability to collect interest and principal and the Group’s previous experience of similar forbearance action. As part of this process, the Group will evaluate the borrower’s payment performance against the modified contractual terms and consider various behavioural indicators.

Generally, forbearance is a qualitative indicator of default and credit impairment and expectations of forbearance are relevant to assessing whether there is a significant increase in credit risk (see Note xx). Following forbearance, a customer needs to demonstrate consistently good payment behaviour over a period of time before the exposure is no longer considered to be in default/credit-impaired or the PD is considered to have decreased such that the loss allowance reverts to being measured at an amount equal to 12-month ECLs.

Inputs into measurement of ECLs

The key inputs into the measurement of ECLs are likely to be the term structures of the following variables:

- PD;
- loss given default (LGD); and
- exposure at default (EAD).

These parameters will be derived from internally developed statistical models and other historical data that leverage regulatory models. They will be adjusted to reflect forward-looking information as described below.

PD estimates are estimates at a certain date, which will be calculated based on statistical rating models and assessed using rating tools tailored to the various categories of counterparties and exposures. These statistical models will be based on internally compiled data comprising both quantitative and qualitative factors. Where it is available, market data may also be used to derive the PD for large corporate counterparties. If a counterparty or exposure migrates between rating classes, then this will lead to a change in the estimate of the associated PD. PDs will be estimated considering the contractual maturities of exposures and estimated prepayment rates.

LGD is the magnitude of the likely loss if there is a default. The Group will estimate LGD parameters based on the history of recovery rates of claims against defaulted counterparties. The LGD models will consider the structure, collateral, seniority of the claim, counterparty industry and recovery costs of any collateral that is integral to the financial asset. For loans secured by retail property, loan-to-value (LTV) ratios are likely to be a key parameter in determining LGD. LGD estimates will be calibrated for different economic scenarios and, for real estate lending, to reflect possible changes in property prices. They will be calculated on a discounted cash flow basis using the effective interest rate as the discounting factor.
45. Standards issued but not yet effective (continued)

IFRS 9 Financial Instruments (continued)

ii. Impairment – Financial assets, loan commitments and financial guarantee contracts (continued)

Inputs into measurement of ECLs (continued)

EAD represents the expected exposure in the event of a default. The Group will derive the EAD from the current exposure to the counterparty and potential changes to the current amount allowed under the contract, including amortisation, and prepayments. The EAD of a financial asset will be the gross carrying amount at default. For lending commitments and financial guarantees, the EAD will consider the amount drawn, as well as potential future amounts that may be drawn or repaid under the contract, which will be estimated based on historical observations and forward-looking forecasts. For some financial assets, the Group will determine EAD by modelling the range of possible exposure outcomes at various points in time using scenario and statistical techniques.

As described above, and subject to using a maximum of a 12-month PD for financial assets for which credit risk has not significantly increased, the Group will measure ECLs considering the risk of default over the maximum contractual period (including any borrower’s extension options) over which it is exposed to credit risk, even if, for risk management purposes, the Group considers a longer period. The maximum contractual period extends to the date at which the Group has the right to require repayment of an advance or terminate a loan commitment or guarantee.

For retail overdrafts and credit card facilities and certain corporate revolving facilities that include both a loan and an undrawn commitment component, the Group will measure ECLs over a period longer than the maximum contractual period if the Group’s contractual ability to demand repayment and cancel the undrawn commitment does not limit the Group’s exposure to credit losses to the contractual notice period. These facilities do not have a fixed term or repayment structure and are managed on a collective basis. The Group can cancel them with immediate effect but this contractual right is not enforced in the normal day-to-day management, but only when the Group becomes aware of an increase in credit risk at the facility level. This longer period will be estimated taking into account the credit risk management actions that the Group expects to take and that serve to mitigate ECLs. These include a reduction in limits and cancellation of the facility.

Where modelling of a parameter is carried out on a collective basis, the financial instruments will be grouped on the basis of shared risk characteristics that include:

- instrument type;
- credit risk gradings;
- collateral type;
- LTV ratio for retail mortgages;
- date of initial recognition;
- remaining term to maturity;
- industry; and
- geographic location of the borrower.

The groupings will be subject to regular review to ensure that exposures within a particular group remain appropriately homogeneous.
Notes to the consolidated financial statements (continued)

45. Standards issued but not yet effective (continued)

IFRS 9 Financial Instruments (continued)

ii. Impairment – Financial assets, loan commitments and financial guarantee contracts (continued)

Inputs into measurement of ECLs (continued)

For portfolios in respect of which the Group has limited historical data, external benchmark information will be used to supplement the internally available data. The portfolios for which external benchmark information represents a significant input into measurement of ECLs are as follows.

<table>
<thead>
<tr>
<th>Portfolio</th>
<th>Description</th>
<th>Exposure</th>
<th>PD</th>
<th>LGD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Portfolio 1</td>
<td>[describe]</td>
<td>[Amount]</td>
<td></td>
<td>Moody’s default study</td>
</tr>
<tr>
<td>Portfolio 2</td>
<td>[describe]</td>
<td>[Amount]</td>
<td></td>
<td>Moody’s default study</td>
</tr>
<tr>
<td>Portfolio 3</td>
<td>[describe]</td>
<td>[Amount]</td>
<td></td>
<td>Moody’s default study</td>
</tr>
</tbody>
</table>

External benchmarks used

Moody’s default study  S&P recovery studies

Forward-looking information

Under IFRS 9, the Group will incorporate forward-looking information into both its assessment of whether the credit risk of an instrument has increased significantly since initial recognition and its measurement of ECLs. The Group will formulate a ‘base case’ view of the future direction of relevant economic variables and a representative range of other possible forecast scenarios based on advice from the Group Market Risk Committee and economic experts and consideration of a variety of external actual and forecast information. This process will involve developing two or more additional economic scenarios and considering the relative probabilities of each outcome. External information may include economic data and forecasts published by governmental bodies and monetary authorities in the countries where the Group operates, supranational organisations such as the Organisation for Economic Co-operation and Development and the International Monetary Fund, and selected private sector and academic forecasters.

The base case will represent a most-likely outcome and be aligned with information used by the Group for other purposes, such as strategic planning and budgeting. The other scenarios will represent more optimistic and more pessimistic outcomes. The Group will also periodically carry out stress-testing of more extreme shocks to calibrate its determination of these other representative scenarios.

The Group has identified and documented key drivers of credit risk and credit losses for each portfolio of financial instruments and, using an analysis of historical data, has estimated relationships between macro-economic variables and credit risk and credit losses. These key drivers include interest rates, unemployment rates and GDP forecasts. Predicted relationships between the key indicators and default and loss rates on various portfolios of financial assets have been developed based on analysing historical data over the past 10 to 15 years.

The economic scenarios used will be approved by the Group Credit Committee.

Impact assessment

The most significant impact on the Group’s financial statements from the implementation of IFRS 9 is expected to result from the new impairment requirements. Impairment losses will increase and become more volatile for financial instruments in the scope of the IFRS 9 impairment model.

The Group has estimated that, on the adoption of IFRS 9 at 1 January 2018, the impact of the increase in loss allowances (before tax) will be approximately €700 million. Loss allowances on unsecured products with longer expected lives such as overdrafts and credit cards will be most affected by the new impairment requirements.
45. Standards issued but not yet effective (continued)

IFRS 9 Financial Instruments (continued)

iii. Classification – Financial liabilities

IFRS 9 largely retains the existing requirements in IAS 39 for the classification of financial liabilities. However, under IAS 39 all fair value changes of financial liabilities designated as at FVTPL are recognised in profit or loss, whereas under IFRS 9 these fair value changes will generally be presented as follows:

- the amount of the change in the fair value that is attributable to changes in the credit risk of the liability will be presented in OCI; and
- the remaining amount of the change in the fair value will be presented in profit or loss.

The Group has designated debt securities issued as at FVTPL when it holds related derivatives at FVTPL and designation therefore eliminates or significantly reduces an accounting mismatch that would otherwise arise. The amount of the changes in fair value attributable to changes in credit risk of these liabilities that were recognised in profit or loss in 2017 under IAS 39 is disclosed in Note xx. On the adoption of IFRS 9, such changes in fair value will be recognised in OCI, although the amount recognised in OCI each year will be variable. The cumulative amount recognised in OCI will be nil if the designated liabilities are repaid at maturity.

iv. Derecognition and contract modification

IFRS 9 incorporates the requirements of IAS 39 for the derecognition of financial assets and financial liabilities without substantive amendments. However, it contains specific guidance for the accounting when the modification of a financial instrument not measured at FVTPL does not result in derecognition. Under IFRS 9, the Group will recalculate the gross carrying amount of the financial asset (or the amortised cost of the financial liability) by discounting the modified contractual cash flows at the original effective interest rate and recognise any resulting adjustment as a modification gain or loss in profit or loss. Under IAS 39, the Group does not recognise any gain or loss in profit or loss on modifications of financial liabilities and non-distressed financial assets that do not lead to their derecognition.

The Group expects an immaterial impact from adopting these new requirements.

v. Hedge accounting

When initially applying IFRS 9, the Group may choose as its accounting policy to continue to apply the hedge accounting requirements of IAS 39 instead of the requirements in Chapter 6 of IFRS 9. The Group has elected to continue to apply IAS 39. However, the Group will provide the expanded disclosures on hedge accounting introduced by IFRS 9’s amendments to IFRS 7 Financial Instruments: Disclosures because the accounting policy election does not provide an exemption from these new disclosure requirements.

vi. Disclosures

IFRS 9 will require extensive new disclosures, in particular about hedge accounting, credit risk and ECLs.

vii. Impact on capital planning

The Group’s lead regulator has issued guidelines on transition requirements for the implementation of IFRS 9. The guidelines allow a choice of two approaches to the recognition of the impact of adoption of the standard on regulatory capital:

1. phasing in the full impact on a straight-line basis over a five-year period; or
2. recognising the full impact on the day of adoption.

The Group has decided to adopt the first approach.

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a. The example disclosures presented in this supplement assume that the primary basis for capital management is regulatory capital resources. However, other presentations are possible. Banks will be subject to specific local regulatory capital requirements. The example disclosures are not designed to comply with any particular regulatory framework.
Notes to the consolidated financial statements (continued)

45. Standards issued but not yet effective (continued)

IFRS 9 Financial Instruments (continued)

vii. Impact on capital planning (continued)

The principal impact on the Group’s regulatory capital of the implementation of IFRS 9 will arise from the new impairment requirements.

Under current regulatory requirements, impairment provisions are dealt with differently depending on whether a particular portfolio is under the IRB or the standardised approach.

- **IRB approach:** The capital requirement is calculated based on the gross exposure. Any shortfall between eligible accounting provisions and regulatory expected losses is deducted from capital resources and any excess is added back to Tier 2 (up to a certain limit). Approximately 80% of the Group’s loans and advances to customers are subject to the IRB approach. The Group’s assessment indicates that the impact on capital resources of the implementation of IFRS 9 for the IRB portfolios will be a reduction in CET1 of approximately €80 million before adjustments for phasing in (being the excess of IFRS 9 loss allowances over regulatory provisions). This will result in a reduction in CET1 of approximately €16 million as at 1 January 2018 after adjustments for phasing in. The Group does not expect a significant impact on total capital.

- **Standardised approach:** The capital requirement is calculated based on the gross exposures net of specific provisions – i.e. net exposure. IFRS 9 is expected to increase the loss allowances associated with individual assets, and therefore the resulting net exposure and the capital requirement will fall. However, this reduction in the capital requirement will be outweighed by the one-for-one deduction of the increased IFRS 9 loss allowance from capital resources. Approximately 20% of the Group’s loans and advances to customers are subject to the standardised approach. The Group’s assessment indicates that the impact on capital resources of the implementation of IFRS 9 for the standardised portfolios will be a reduction in CET1 and total capital of approximately €100 million before adjustments for phasing in, and a reduction in CET1 and total capital of approximately €20 million as at 1 January 2018 after adjustments for phasing in.

viii. Transition

Changes in accounting policies resulting from the adoption of IFRS 9 will generally be applied retrospectively, except as described below.

- The Group will take advantage of the exemption allowing it not to restate comparative information for prior periods with respect to classification and measurement (including impairment) changes. Differences in the carrying amounts of financial assets and financial liabilities resulting from the adoption of IFRS 9 will generally be recognised in retained earnings and reserves as at 1 January 2018.

- The following assessments have to be made on the basis of the facts and circumstances that exist at the date of initial application.
  - The determination of the business model within which a financial asset is held.
  - The designation and revocation of previous designations of certain financial assets and financial liabilities as measured at FVTPL.
  - The designation of certain investments in equity instruments not held for trading as at FVOCI.
  - For a financial liability designated as at FVTPL, the determination of whether presenting the effects of changes in the financial liability’s credit risk in OCI would create or enlarge an accounting mismatch in profit or loss.
  - If a debt investment security has low credit risk at 1 January 2018, then the Group will determine that the credit risk on the asset has not increased significantly since initial recognition.
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