EFRAG Secretariat: Galina Borisova, Didrik Thrane-Nielsen

This paper has been prepared by the EFRAG Secretariat for discussion at a public meeting of EFRAG FR TEG. The paper forms part of an early stage of the development of a potential EFRAG position. Consequently, the paper does not represent the official views of EFRAG or any individual member of the EFRAG FRB or EFRAG FR TEG. The paper is made available to enable the public to follow the discussions in the meeting. Tentative decisions are made in public and reported in the EFRAG Update. EFRAG positions, as approved by the EFRAG FRB, are published as comment letters, discussion or position papers, or in any other form considered appropriate in the circumstances.

PIR IFRS 9 Impairment – Feedback received

Objective

1 The objective of this paper is to provide EFRAG FR TEG with a summary of a feedback received by the IASB on its Request for Information ('RFI') on PIR of IFRS 9 - *Impairment*.

Structure of the paper

2 This paper is structured as follows:

- Overall feedback
- Question 1 - Impairment
- Question 2 - The general approach to recognising expected credit losses
- Question 3 - Determining significant increases in credit risk
- Question 4 - Measuring expected credit losses
- Question 5 - Simplified approach
- Question 6 - Purchased or originated credit-impaired financial assets
- Question 7 - Interaction of impairment requirements with other requirements
- Question 8 - Transition
- Question 9 - Credit risk disclosures
- Question 10 - Other matters.

3 The IASB applied the following terminology to indicate the portion of respondents with a particular view:

(a) almost all — all except a very small minority;

(b) most — large majority, with more than a few exceptions;

(c) many — small majority or large minority;

(d) some — small minority, but more than a few; and

(e) a few — a very small minority.

Overall feedback

4 Overall feedback received by the IASB was positive. In particular it was noted that IFRS 9 impairment requirements result in more timely recognition of credit losses compared to IAS 39 *Financial Instruments: Recognition and Measurement,* work as intended and provide useful information about the effect of credit risk on the future cash flows.

5 Most respondents commented that applying the impairment requirements during periods of uncertainty, such as the COVID-19 pandemic or the recent geopolitical and economic uncertainties, demonstrated the robustness of the model. However, some said the requirements have yet to be tested in a scenario of significant defaults.

6 Although the PIR feedback did not identify any fatal flaws, respondents identified specific matters where entities experience application challenges and diversity in practice, mostly in areas that require use of judgement. They focused on:

(a) application issues arising from the **interaction between the impairment** requirements and the requirements in IFRS 9 for **modifications, derecognition and write-off** (Question 7); and

(b) diversity in application of, and potential improvements to, the **disclosure requirements on credit risk** in IFRS 7 *Financial Instruments: Disclosures* (Question 9).

7 Feedback generally suggested the IASB to make specific improvements mostly in the form of application guidance and illustrative examples, no major amendments were recommended.

Question 1 – Impairment

8 The respondents confirmed that impairment requirements result in a more timely recognition of credit losses than under IAS 39. However, a few respondents:

(a) noted that because the model is based on *expected* credit losses, some credit losses do not eventually crystalise resulting in volatility in profit or loss; or

(b) reiterated concerns about procyclicality resulting from movements of assets between stage 1 and stage 2.

9 Some respondents also commented on:

(a) The complexity of the impairment requirements in IFRS 9 which involves making multiple judgements and using forward-looking information.

(b) Costs vs benefits. High ongoing costs of maintaining, adjusting and auditing the model were mentioned, which were, however, outweighed by more timely recognition of credit losses, more useful information to investors and better alignment with credit risk management.

10 It was also noted that feedback from insurance companies should be considered later during PIR of IFRS 17.

EFRAG comment letter

11 The feedback received by the IASB is in line with the EFRAG response to this question.

Question 2 - The general approach to recognising expected credit losses

12 Almost all respondents supported the general approach, did not identify any fatal flaws, but suggested targeted improvements in the following areas:

ECL for intragroup financial instruments

13 Many respondents said the costs of applying the general approach to intragroup loans often outweigh the benefits gained by investors from the resulting information. They said this problem mostly arises when preparing separate financial statements.

14 Respondents indicated these transactions are often not based on commercial terms and entities lack reliable data to calculate and recognise ECL. Similar issue was reported for intercompany financial guarantee contracts. Some respondents suggested the IASB provide application guidance on how entities can reliably recognise ECL for these transactions.

Other respondents suggested the IASB provide an exemption from, or a simplification of, the requirements to recognise ECL for these transactions.

EFRAG comment letter

15 EFRAG has identified this issue as medium priority in its comment letter and suggested the IASB provides simplified rules for accounting for these loans.

Initial ECL for purchased financial assets

16 Some respondents said that the requirement to recognise at least 12-month ECL at each reporting date results in partial double counting of ECL when a financial instrument is first recognised. This is because ECL is already reflected in the fair value of the asset on initial recognition.

17 Despite the fact that this matter has been considered by the IASB when developing the impairment requirements (see paragraphs BC5.87–BC5.95 of the Basis for Conclusions on IFRS 9), a few respondents suggested to reconsider the requirement in the context of purchased financial assets that are **not** credit impaired. In their view, this problem is most pronounced for such assets and the reporting outcome reduces the usefulness of information about acquisitions to investors.

18 However, there were mixed views on how to solve this issue. A few respondents suggested to apply POCI requirements to **all** purchased assets. A prudential regulator suggested adding specific disclosure requirements and some respondents suggested that double-counting effect is not significant and any action would outweigh the benefits.

EFRAG comment letter

19 EFRAG did not report this issue in its comment letter. The EFRAG high priority issue about "all cash shortfalls" was considered by the IASB in analysing Question 7.

Question 3 - Determining significant increases in credit risk

20 Respondents supported the principle-based approach in IFRS 9 to assess SICR and did not identify any fatal flaws with the requirements. They, however, noted that requirements were not applied consistently and suggested to provide application guidance or illustrative examples in the following key areas:

(a) *what constitutes a significant increase in credit risk* – further guidance on SICR occurrence was requested. For example:

(i) to supplement the objective of SICR assessment by discussing what a reasonable SICR approach should achieve.

(ii) to add further illustrative examples of SICR thresholds and discuss linkage to factors an entity considers for risk management or regulatory reporting purposes (e.g. assessments for watchlist or special mention assets).

(iii) To improve disclosures about SICR thresholds (see Question 9).

(b) *use of collective assessment for SICR* – many respondents asked for application guidance or illustrative examples to support consistent use of collective assessment for SICR. For example:

(i) illustrating a collective assessment of the impact from emerging risks and events to identify vulnerable sectors and borrowers, not yet reflected in individual assessments;

(ii) clarifying when a collective assessment is required, because some entities interpret paragraph B5.5.1 of IFRS 9 to mean the use of collective assessment for SICR is purely optional.

21 Respondents also identified application questions about how to determine SICR in specific fact patterns or for specific instruments and suggested to provide illustrative examples. For example, what is considered the date of initial recognition for purposes of assessing SICR if a loan is recognised from the draw-down of a credit card.

EFRAG comment letter

22 EFRAG in its comment letter identified the issue with collective assessment of SICR and paragraph B5.5.1 of IFRS 9 as a medium priority, noted that collective assessment should be maintained and suggested the IASB provide more real-life illustrative examples.

Question 4 - Measuring expected credit losses

23 Almost all respondents provided feedback about the measurement of ECL and did not identify any fatal flaws with the principle-based requirements. They, however, identified diversity in practice and asked for more guidance in the following areas to support a greater consistency:

(a) forward-looking scenarios;

(b) post-model adjustments or management overlays (PMAs);

(c) measuring ECL for loan commitments; and

(d) reflecting the effect of financial guarantees in measuring ECL.

24 Some respondents suggested to consider the effects of climate-related risks and that the IASB explicitly requires to include its effects in ECL measurement.

25 Other application questions, such as how to measure ECL for some contractually linked instruments were identified.

Forward-looking scenarios

26 Many respondents noted diversity in practice regarding the number of forward-looking scenarios entities use and the weights they assign to those scenarios. They suggested the IASB clarify the objective of the scenario analysis and specify that entities need to consider material non-linearities in the distribution of potential credit losses when defining scenarios.

27 Some regulators and accounting firms asked for additional guidance as it would help them to challenge the application of multiple scenarios.

28 Many respondents suggested incorporating those key conclusions of IFRS Transitional Resource Group on this topic into IFRS 9.

EFRAG comment letter

29 EFRAG did not ask for additional guidance on this topic as it considered that the diversity of methods of estimating ECL is inherent in the principle-based approach to impairment of IFRS 9 and that lack of comparability is offset by increased relevance of the resulting information.

Post-model adjustments (PMAs) or management overlays

30 Respondents across all stakeholder groups noted that, in recent years, the use of PMAs has significantly increased to capture the impact of emerging risks.

31 The preparers said that PMAs compensate for the lack of historical information and other limitations of statistical models and are, therefore, a useful tool.

32 The regulators, accounting firms and standard setters reported diversity in how PMAs are recognised and a general lack of transparency about how a PMA is determined, reducing the usefulness of the resulting ECL information to investors. They suggested to add

application guidance to IFRS 9 and additional disclosure requirements to IFRS 7 to help achieve greater consistency (see also Question 9).

EFRAG comment letter

33 The feedback is largely consistent with EFRAG response on this topic. In its comment letter EFRAG suggested that guidance in which situations and for how long the post-model adjustments could be used and that their use should be consistent with objective and verifiable evidence would be helpful.

Loan commitments

34 Some respondents identified application challenges on the measurement of ECL for revolving credit facilities such as credit cards and overdraft facilities. They asked for additional application guidance about:

(a) the characteristics of loan commitments that fall in scope of the exception in paragraph 5.5.20 of IFRS 9 (for example, how to interpret ‘managed on a collective basis’ referred to in paragraph B5.5.39(c) of IFRS 9); and

(b) how to determine the maximum period to consider in measuring ECL on revolving credit facilities such as credit cards.

35 These respondents suggested to include in IFRS 9 the education material issued by the IASB in May 2017 and the deliberations of the ITG.

36 Some other application questions were raised by a few respondents, including the accounting treatment for loan commitments issued at below-market terms or whether specific types of commitments are subject to the impairment requirements.

37 Two accounting firms and a standard setter considered that this issue does not have a material impact on financial statements and the usefulness of information to investors.

EFRAG comment letter

38 The feedback on this topic is largely consistent with EFRAG comment letter which suggested to clarify what is meant by ‘managed on collective basis’, to include in IFRS 9 guidance and the key messages from the IASB educational video and to provide guidance how to connect existing rules on modification and derecognition with the characteristics of revolving credit facilities. This issue was identified by EFRAG as medium priority.

Financial guarantee contracts held

39 Some respondents reported diversity in practice in how to assess whether a financial guarantee contract (FGC) held by an entity is ‘integral to’ or ‘part of’ the contractual terms, and thus required to be included in the measurement of ECL, especially when the FGC is not an explicit contractual term of the instrument. These respondents suggested to provide a non-exhaustive list of factors for entities to consider when applying paragraph B5.5.55 of IFRS 9.

40 It was noted that although a guidance was developed by the accounting firms, it is not consistent across all firms and results in diversity in practice.

41 The diversity in practice was also noted regarding about the timing for recognition of the reimbursement asset, its measurement and recognition of any fees paid upfront.

42 Some respondents said there are no explicit requirements in IFRS 9 or other IFRS Accounting Standards on accounting for FGCs that are not considered integral to the contractual terms (‘non-integral FGC’) and suggested to develop requirements specific to non-integral FGCs or permit entities to reflect the effect of all FGCs in the measurement of ECL, even if not integral to the contract.

43 Two accounting firms considered these issues are not of high priority because in many cases, the ultimate net impact on financial statements is similar regardless of whether the FGC is considered integral or not. In their view, accepted practices have been established and the diversity is limited.

EFRAG comment letter

44 EFRAG identified this issue as medium priority and the feedback received by the IASB is largely in line with EFRAG concerns. In particular EFRAG suggested to provide application guidance on how to account for financial guarantees and credit enhancements which are not part of the contractual terms.

Question 5 - Simplified approach

45 Respondents who provided feedback on this topic noted that the simplified approach is widely used by non-financial institutions and did not report any fatal flaws.

46 However some respondents reported some application challenges such as including forward-looking information in a provision matrix, suggesting the IASB provide further application guidance or educational material. Respondents also asked for further guidance how to apply the simplified approach to assets for which there is no sufficient historical data (for example, assets originated from a new business).

47 Some respondents even suggested the IASB extend the scope of the simplified approach to other financial instruments (such as intragroup loans) to reduce the cost of applying the general approach to those instruments.

EFRAG comment letter

48 EFRAG did not identify any issues with the application of the simplified approach.

Question 6 - Purchased or originated credit-impaired financial assets

49 Most respondents considered that generally, the requirements in IFRS 9 for POCI financial assets can be applied consistently and faithfully reflect the underlying economic substance of these transactions. Nonetheless, respondents identified some application challenges and asked for more guidance in the following areas:

(a) *assessing whether a modified financial asset is originated credit-impaired* – some respondents identified a diversity in how entities assess whether modification of a restructured asset results in derecognition of the original asset and recognition of a new asset, and whether that asset represents an originated credit-impaired asset. The resulting impact on the ECL amount could be material, depending on whether the asset is derecognised or not. Respondents also said it is challenging to determine the fair value at initial recognition for originated credit-impaired assets that arise from a substantial modification due to the lack of observable purchase price.

(b) *accounting for improvements in credit risk after initial recognition of a POCI financial asset* - some respondents reported diversity in how entities recognise the effect of these improvements in the statement of financial position - some recognise it as a negative entry to the ECL allowance, others - as an adjustment to the gross carrying amount of a POCI financial asset. They suggested the IASB clarify this issue.

EFRAG comment letter

50 The feedback is mostly in line with EFRAG response. EFRAG identified this issue as a medium priority and asked for clarification on when the financial assets newly recognised after restructuring can be considered as POCI and how to present the movements in ECL on POCI financial assets, especially in the case where there is an improvement in credit quality.

Question 7 - Interaction of impairment requirements with other requirements

51 This is one of the topics which received the most feedback. Although the requirements were well understood, respondents identified several challenges and application questions on interaction of the IFRS 9 impairment requirements with requirements on modification, write-off and derecognition.

52 On interaction with other IFRS standards application questions mainly related to accounting for ECL in cases of revisions of receipts from trade receivables arising from IFRS 15 or potential effects on ECL from the unguaranteed residual value of the asset underlying a finance lease applying IFRS 16.

Distinguishing credit losses from other changes in expected cash flows

53 Many respondents acknowledged that the definition of credit losses in Appendix A of IFRS 9 refers to *all cash shortfalls*, but noted that IFRS 9 does not provide sufficient guidance for entities to distinguish between credit losses, modification losses (paragraph 5.4.3), revision of estimated contractual cash flows (paragraph B5.4.6), derecognition, including forgiveness (paragraph 3.2.3) and write-offs (paragraph 5.4.4).

54 Most feedback related to two questions:

(a) does the reason for any cash shortfalls (credit vs non-credit related) affect the accounting outcome, including presentation of losses; and

(b) what is the order in which entities shall apply IFRS 9 requirements, i.e. are the requirements for derecognition, modifications or impairment applied first?

55 Respondents noted that diversity in practice on these questions could have significant consequences for the application of the impairment requirements and provided an example of when a law is expected to be enacted that would require lenders in a jurisdiction to offer payment holidays for a specified period. In their view it was unclear if an entity shall reflect the change in expected cash flows as:

(a) a change in estimate of ECL;

(b) a modification; or

(c) a change in estimated cash flows in accordance with paragraph B5.4.6.

56 Respondents noted that a related issue about forgiveness of cash flows on lease liabilities was discussed at the IFRS IC and some suggested to include the IFRS IC conclusions into IFRS 9, but others suggested that this topic requires a broader consideration by the IASB.

57 Many respondents assigned high or medium priority to this issue, because the definition of credit losses is fundamental to impairment requirements.

58 All the respondents supported joint consideration of findings arising from both PIRs of IFRS 9 in the IASB pipeline research project on amortised cost measurement.

Write-off

59 Some respondents noted various challenges related to recognition and presentation of write-offs, for example IFRS 9 was not clear or resulted in the counterintuitive outcomes in the following cases:

(a) accounting for write-offs, particularly for an asset for which the write-off is greater than the ECL loss allowance (should the write-off be accounted for by reducing the gross carrying amount of a financial asset or considered as crystallisation of losses already reflected in ECL, thus only be accounted for the difference as an additional impairment loss).

(b) the recognition of recoveries from amounts previously written off (whether recoveries are recognised when cash is received or when they become virtually

certain). Some respondents also said that the lack of guidance on presentation of these recoveries leads to diversity in the statement of profit or loss.

EFRAG comment letter

60 The feedback on this question is in line with EFRAG response.

61 EFRAG reported the issue of the interpretation of 'all cash shortfalls' in the light of the recent IFRS IC decision as high priority issue in Question 2 where it asked to clarify whether and how the expression "all cash shortfalls" used in the Appendix A of IFRS 9 should be interpreted within the scope of concessions from the lender due to financial difficulties of the borrower.

62 EFRAG as well reported the issues of interaction of impairment, modification and derecognition requirements as high priority.

Question 8 – Transition

63 Respondents did not provide a significant amount of feedback on this topic. Most respondents that provided feedback found the transition requirements generally worked well and the reliefs provided were helpful in reducing costs for preparers.

EFRAG comment letter

64 The feedback on this question is in line with EFRAG response.

Question 9 - Credit risk disclosures

65 This is another area where IASB received the most feedback. Most respondents were of the view that there are no fatal flaws about the credit risk disclosure requirements in IFRS 7. They also noted that the combination of disclosure objectives and minimum disclosure requirements is the right approach for a general purpose - rather than industry specific - accounting standard such as IFRS 7.

66 However, most respondents (except some preparers), also said the requirements are not applied consistently and the quantity, quality, and level of disaggregation of information disclosed by different entities vary significantly. This reduces comparability between similar entities and limits the usefulness of information to investors.

67 Many suggestions were provided to improve consistency, such as:

(a) *PMAs* - adding minimum disclosure requirements about PMAs or stating explicitly that PMAs are in scope of credit risk disclosure requirements in IFRS 7.

(b) *Sensitivity analysis* - adding specific requirements for an ECL sensitivity analysis to assist investors better understand and analyse the effects of future uncertainties in the ECL. Currently IFRS 7 has no specific requirements to disclose information about the sensitivity of the ECL allowance to changes in key assumptions.

(c) *Determining SICR* - clarifying the need to disclose relevant information about SICR thresholds which triggered movements of assets between stages, including the extent an entity relies on backstops, such as the 30 days past due rebuttable presumption in paragraph 5.5.11 of IFRS 9.

68 Several other areas with a lack of consistency in disclosures, were noted by some respondents, for example:

(a) disclosure about scenarios;

(b) the reconciliation of the ECL allowance and the related changes in gross carrying amounts of assets, and

(c) the effect of climate-related risks in the measurement of ECL.

69 The respondents also noted that IFRS 7 applies to entities of different sizes and industries and asked the IASB to consider the proportionality of any potential improvements, for example by considering exemptions from some of the current disclosure requirements for entities that apply the simplified approach.

70 Some other respondents (mostly preparers) considered that IFRS 7 already provides sufficient guidance and strikes the costs-benefits balance. These respondents are concerned that any potential improvements would involve significant costs for preparers which would exceed any incremental benefit to be gained by investors.

71 Some respondents also highlighted the positive role of auditors or enforcers in supporting greater consistency in how entities provide the credit risk disclosures. For example regulatory or industry group recommendations in some jurisdictions result in improved consistency of disclosures provided.

EFRAG comment letter

72 The feedback on this topic fairly reflects the mixed feedback received by EFRAG. EFRAG rated this as medium priority issue and asked for more guidance and examples to increase consistency.

Question 10 - Other matters

73 Some respondents identified other matters that they think the IASB should consider as part of the PIR of the impairment requirements. Most of this feedback related to the topic of financial guarantee contracts (FGCs) issued by an entity, for example, lack of guidance in IFRS 9 related to accounting of FGCs where premiums are received over the life of the contract, rather than upfront. Respondents said some entities recognise a receivable for future premiums not yet due and other entities do not recognise such premiums, resulting in different accounting outcomes.

EFRAG comment letter

74 EFRAG reported the issue discussed by the IASB in its response to Question 4 on financial guarantees.

75 In this question EFRAG reminded about the need to reconsider the recycling of equity instruments measured at FVOCI during PIR of IFRS 17.

EFRAG working groups discussions

EFRAG FIWG

76 EFRAG FIWG at its meeting on 5 December 2023 was asked to provide its comments in writing, because the session was devoted to the presentation of newly published EBA monitoring report on the status of IFRS 9 implementation by EU institutions (please see Appendix A for more details). At the time of writing, we did not receive any comments from EFRAG FIWG members.

EFRAG User Panel

77 EFRAG User Panel discussed this topic with a focus on credit risk disclosure requirements at its meeting on 7 December 2023.

78 Members generally agreed that impairment model works as intended and results in more timely recognition of credit losses compared to IAS 39 model.

79 On integration of climate risks some members noted that insurance industry is able to price climate-related and geopolitical risks and questioned whether the evidence about this was provided.

80 It was also noted that integration of climate-related and other risks depends on the type of data provided. In market data these risks are already incorporated in the market prices.

81 IASB representative noted the interconnection between climate-related and credit risk. On the question what IASB meant by 'other uncertainties' the IASB representative replied that it could be for example forex risk and some other risks, the IASB intention was to keep the scope broad.

Questions to EFRAG FR TEG

82 Does EFRAG FR TEG have any comments on the summary of feedback received by the IASB on the PIR of impairment requirements?

Appendix A

83 EFRAG FIWG 6 December 2023 - EBA monitoring report presentation EBA representatives presented the 2023 EBA monitoring report *IFRS 9 Implementation by EU Institutions* with the main focus on the ECL outputs and related modelling aspects, emerging risks and backtesting. The findings were essentially similar to the previous monitoring report issued in 2021. This year report provided clearer and more assertive expectations.

84 The report showed that prudential concerns on SICR practices which could delay timely ECL recognition and stage transfer remain (e.g., use of collective approach to assess SICR, large application of low credit risk exemption, etc).

85 Financial institutions continue use overlays extensively and very few institutions incorporated climate risks in their ECL models.

86 According to the report, incorporation of forward-looking information provided only limited impact and sometimes extensively long forecasting periods and time horizons were used. The incorporation of backtesting in the periodic review of the models was very limited.

87 One member asked to clarify the EBA finding on the use of too long-term scenarios. Banks have to reflect the maturity of their loan portfolio, which can be 30 years for some mortgages. The EBA representative responded that this related to the analytical projection which according to central banks estimation should be around 3-5 years, the rest of the contract term could be covered by using through the cycle and more long-term average assumptions. 10-20 years analytical projections are not considered reliable.

88 On the question of whether EBA expects supervisors to provide a common scenario of a GDP forecast, the EBA representative responded that EBA does not expect that, but a follow-up from supervisors in this respect.

89 On the question whether EBA findings would require changes to IFRS 9, the EBA representative responded that some clarifications on the objective of the standard, the use of scenarios to determine ECL, SICR, etc would be useful from EBA perspective.

90 On the question of lack of application of collective assessment of SICR, EBA representatives noted that it comes from a lack of guidance on whether it should be done on a simultaneous basis with individual assessments, or by using the top-down approach as described in the standard and also in which order it should be applied. For example, EBA envisaged a kind of waterfall structure starting with individual assessment, then - with the collective assessment with shared credit risk characteristics and then - with a top-down approach.

91 On the question of whether overlays could be used in the future or should be incorporated in the model, EBA representative replied that it will be assessed on a case-by-case basis and depend on the type of risks they cover and whether the related events are recent.

92 On the question of best practices for backtesting, the EBA representative replied that the expectation is that banks should develop effective backtesting methodologies, the supervisors will not provide the model. The EBA report highlighted what was not considered best practices.