EFRAG Financial reporting

EFRAG FR TEG meeting
5 July 2023
Paper 04-01
EFRAG Secretariat: Laura Abeni, Galina Borisova, Sapna Heeralall, 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 – Draft Comment letter
Cover Note

Objective

1 The objective of the session is:

(a) to provide an overview of academic research on how the expected credit loss ('ECL') model works (presentation by Zoltán Novotny-Farkas); and

(b) to approve for publication EFRAG's Draft Comment Letter ('DCL') in response to the IASB's *Request for Information: Post-implementation Review IFRS 9 Financial Instruments – Impairment* ('RFI').

2 On 3 May 2023, the EFRAG FRB delegated EFRAG FR TEG to collect European views on the effects of applying the impairment requirements in IFRS 9 and to finalise EFRAG's response to this RFI. Therefore, the EFRAG's Draft Comment Letter and Final Comment Letter ('FCL') will be approved by EFRAG FR TEG.

3 Questions for EFRAG FR TEG are in agenda paper 04-03 and in paragraphs 65 to 69 of this cover note.

Background

RFI

4 The IASB launched a call for stakeholders' feedback on the RFI on 30 May 2023 and the RFI is open for comments until 27 September 2023.

5 The IASB prioritises matters identified in a post-implementation review based on the extent to which evidence gathered during the review shows:

(a) the matter has substantial consequences.

(b) the matter is pervasive.

(c) the matter arises from a financial reporting issue that can be addressed by the IASB or the IFRS Interpretations Committee (IFRS IC).

(d) the benefits of any action would be expected to outweigh the costs. To do this analysis, the IASB would consider the extent of the potential disruption and operational costs from change and the importance of the matter to users of financial statements.

6 The RFI sets out questions in ten sections:

(a) Section one seeks general information on the effect the application of the impairment requirements in IFRS 9 has had on preparers of financial statements, users of financial statements, auditors, and regulators;

(b) Sections two to eight seek information on specific areas of the impairment requirements in IFRS 9, including information on the application of these requirements alongside other requirements in IFRS 9 or in other IFRS Accounting Standards;

(c) Section nine seeks information on application of the disclosure requirements in IFRS 7 for credit risk; and

(d) Section ten seeks other information relevant to the post-implementation review of the impairment requirements.

EFRAG's preliminary work and discussions

7 In anticipation of the publication of RFI and as preliminary work for EFRAG's Draft Comment Letter, EFRAG reached out to its constituents and working groups to collect issues that they think should be raised during this process. In April-July 2022, the EFRAG Secretariat has held several meetings with EFRAG constituents and working groups and came up with a first comprehensive list of issues that have been reported to the IASB Staff, including at the ASAF meeting in September 2022. The initial list of issues was discussed with EFRAG FR TEG-CFSS in the June and September 2022 meetings.

8 This list of issues was discussed at the January 2023 EFRAG FIWG meeting and then the February EFRAG IAWG meeting.

9 EFRAG FR TEG discussed the EFRAG Secretariat's preliminary assessment on prioritisation of issues during its meetings on 9 February 2023 and 16 March 2023.

10 In May 2023, EFRAG FRB was updated on the EFRAG's preparatory work performed for the PIR.

11 The preliminary assessment highlighted that the ECL model works generally as intended and there are no fatal flaws on the clarity and suitability of the core objectives or principles of the impairment requirements. Nevertheless, the preparatory work put in evidence some application issues or diversity in practice that the IASB should address with different levels of priority.

12 EFRAG FRB generally agreed with the preliminary analysis.

Feedback from EFRAG FIWG and IAWG

13 EFRAG IAWG and EFRAG FIWG discussed the EFRAG DCL on 21 June and 26 June 2023, respectively.

EFRAG IAWG

14 Members indicated that it was too soon to comment on the PIR as they are in the process of implementing IFRS 9 and IFRS 17. The IFRS 17 PIR could be a good point also for a review of IFRS 9 and this could be mentioned in the cover letter.

Question 2 – The general approach to recognising expected credit losses

15 Under the premise that is too early to conclude on how the model works, members indicated that the perceived benefits of applying the IFRS 9 ECL requirements to the 2022 comparative numbers appears less than the costs incurred.

16 Members agreed with the consideration in the DCL that the recognition of a "day one losses" on exposures with extremely low risk of default as well as on individually significant high credit quality exposures may not result in a faithful credit risk representation.

Question 3 – Determining significant increases in credit risk

17 Insurers each have their own implementation guidance but, at this stage, it is too early to see to what extent there is consistency among insurers.

18 Members indicated that the credit risk is immaterial, for the moment. They apply the simplification applicable for investments in financial instruments that have low credit risk at the reporting date.

Question 4 – Measuring expected credit losses

19 Members considered that the current requirements to measure ECL work as intended and suggested not to make any changes to them.

20 Members noted that transition to the ECL model resulted in insignificant impact on profit or loss of insurers.

Questions 1, 5, 6, 7, 9 and 10

21 EFRAG IAWG had no comments on the proposed drafting.

Question 8 – Transition

22 EFRAG IAWG noted that the main efforts and costs on transition for insurers related to implementation of IFRS 17 and not IFRS 9.

23 Members commented that they provided comparatives for 2022, with some applying full retrospective approach. Those members whose companies used the reliefs found them useful. However, some members noted that the IFRS 7 disclosures on transition were very costly and burdensome, even more than that required by IFRS 17.

24 One member noted that the biggest impact on transition for insurers related to the reclassification of assets from FVOCI to FVPL category.

25 Members with user background noted that it was too early to comment on the transition from their point of view as only very few financial statements were published.

EFRAG FIWG

Question 1 – Impairment

26 EFRAG FIWG reiterated that overall, the impairment model works well and does not need significant improvements, therefore, it is important to focus on the high priority issues.

Question 2 – The general approach to recognising expected credit losses

27 EFRAG FIWG suggested amending EFRAG's response to Question 2(a) by focusing on the overall message that the general approach works as intended.

28 Members suggested to lower the priority of the issue of high-quality credit exposures and rephrase the relevant paragraphs by deleting the reference to "portfolios" and "insurance companies" as the issue is related to single-name large exposures. Members considered that the IASB could address the issue by mentioning that "best estimate" could be considered as an alternative approach when statistical modelling is not applicable.

29 Members suggested removing the low priority issues "Credit risk and portfolio performance" and "Exposures in stage 1 and stage 2 simultaneously" from the EFRAG draft response to question (a).

30 One member was not in favour of excluding intra-group loans from the general approach as in the US GAAP but suggested applying lifetime ECL without assessing significant increases in credit risk as a simplified rule.

Question 3 – Determining significant increases in credit risk

31 It was agreed to remove the wording 'top-down' and 'bottom-up' and use the wording in IFRS 9 to avoid confusion.

Question 4 – Measuring expected credit losses

32 EFRAG FIWG generally agreed with the EFRAG draft response to this question.

33 Members suggested to rephrase the paragraphs about climate-related risks by connecting them to the other types of forward-looking information incorporated into the ECL modelling. Those should be addressed holistically.

34 Members proposed to lower the importance of this issue and to suggest the IASB to address it across the IFRS Standards within the IASB research project dealing with climate-related risks in IFRS financial statements.

35 On post-model adjustments, members noted different approaches seen in practice and suggested to ask for guidance in which situations and for how long they could be applied. Members noted that these adjustments should not be applied for too long but incorporated into the existing models as soon as feasible.

Question 5 – Simplified approach

36 Members suggested to remove the suggestions for simplified rules from the EFRAG response to question (b).

Questions 6 – Purchased or originated credit-impaired financial assets ('POCI' financial assets) and Question 7 - Application of the impairment requirements in IFRS 9 with other requirements

37 Some members questioned how the accounting for POCI assets interacts with the derecognition requirements and asked to link EFRAG's response of Q6 to Q7 regarding interaction between modification, impairment, and derecognition requirements.

38 One member suggested to include that the entity's approach to derecognition may depend on the background for modifications of the related financial assets and for this reason, when restructuring occurs, generally banks would avoid derecognition.

39 Another member indicated that the issue should be a high priority because there would be different outcomes depending on whether the derecognition requirements are applied or not (i.e., stage 1 ECL versus applying the POCI method). Therefore, the IASB should clarify what are the conditions to apply POCI requirements versus the stage 1 requirements to a loan that has been derecognised and then re-recognised due to substantial modification.

40 Some members did not agree with paragraph 203 of the DCL which indicated that the classification in stage 1 of a restructured loan is counterintuitive and noted that the issue is more related to fair value measurement.

41 Members agreed with the high priority issue on ECL measurement based on expected concession that is not credit risk related (IFRS IC Agenda Decision) and noted the importance of a clarification from the IASB.

Question 8 - Transition

42 EFRAG FIWG did not provide comments on the drafting.

Question 9 – Credit risk disclosures

43 Members, in general, considered that IFRS 7 provides an adequate basis for disclosure requirements. However, they did acknowledge that not all preparers were providing detailed information. They indicated that the issue is to be addressed by the regulators and auditors rather than by standard-setting. It was agreed to reduce the priority of this issue and focus it on management overlays and post-model adjustments.

Question 10 – Other matters

44 Members suggested removing the low priority issue “Timing to move to stage 3” from the EFRAG response to question (a).

Question 9 – Credit risk disclosures

45 As mentioned in paragraph 43, EFRAG FIWG members considered that IFRS 7 provides an adequate basis for disclosures requirements and suggested to reduce the priority of the issue, focusing on management overlays and post-model adjustments.

46 Therefore, the EFRAG Secretariat drafted two alternatives for the EFRAG’s response to Question 9(a):

(a) Alternative 1 has been drafted taking into consideration the feedback collected during the preparatory work and the issue is considered as high priority;

(b) Alternative 2 is a result of the discussions at the EFRAG FIWG meeting and the issue is considered as low priority.

47 The current drafting of cover letter and question 1 is aligned with Alternative 1. The EFRAG Secretariat will update them according to the preference expressed by the EFRAG FR TEG.

Issues not to be reported to the IASB

48 Considering the feedback received during the discussion with EFRAG IAWG and FIWG, the EFRAG Secretariat suggests not reporting to the IASB the following issues previously included in the list of PIR issues collected by the EFRAG Secretariat as preparatory work and reported in the agenda paper 08-02 for EFRAG FR TEG meeting of 16 March 2023.

49 The EFRAG Secretariat notes that some of these issues (issues 13 and 14) question the core principles of the impairment requirements. Therefore, reporting these issues to the IASB would run counter to the feedback that there are no fatal flaws in the ECL model.

50 Furthermore, considering that the preliminary assessment has shown that no significant changes are needed in the ECL model, the EFRAG Secretariat suggests not reporting minor issues (such as issues 5 and 10) which will unnecessarily extend the list.

Simplified rules *(low priority - Issue 5 – Simplified rules for corporates of agenda paper 08-02)*

51 EFRAG also received some suggestions for extending or creating additional simplified rules (in coordination with developments on the Primary Financial Statements project) for:

52 Corporates – which generally do not have the same level of sophistication, systems, and processes as financial institutions to price the financial instruments. Therefore, it is very difficult to calculate ECL at the initial recognition and during the life of the instruments, in particular where loans or guarantees are issued to non-listed entities.

53 Financial instruments with a very high credit quality – calculating ECL on intercompany loans in separate financial statements or to financial instruments with a very high credit quality (i.e., AAA-rated bonds as investments) results in a high level of effort and costs to calculate an ECL that is ultimately immaterial (for detailed discussion, please refer to Question 2 of the RFI).

Timing to move to stage 3 *(low priority - Issue 10 – Timing to move to stage 3 of agenda paper 08-02)*

54 According to paragraph B5.5.33 when a financial asset becomes credit-impaired (and moved to stage 3), an entity shall measure the ECL as the difference between the asset’s gross carrying amount and the present value of estimated future cash flows discounted at the financial asset’s original effective interest rate (‘EIR’). For such assets the EIR is applied to the amortised cost of the financial asset, and not on the gross carrying amount.

55 Constituents reporting this issue highlighted that diversity in practice occurs in relation to when a credit-impaired financial asset is moved to stage 3. In some cases, the credit-impaired financial asset is moved to stage 3 starting from the next reporting date, in other cases this is done during the ongoing reporting period. The different timings have an implication on the application of the EIR (net vs gross basis).

56 Considering the feedback received, EFRAG notes that this issue is not widespread among European constituents. In addition, EFRAG is unaware of any material impacts from the timing differences in the application of the EIR.

57 Therefore, EFRAG considers that the IASB could examine this issue together with other questions on the application of the EIR that will be considered in the context of the IASB pipeline project Amortised Cost Measurement.

Credit risk and portfolio performance *(low priority - Issue 13 – Credit risk and portfolio performance of agenda paper 08-02)*

58 EFRAG has been informed that one criticism to the IFRS 9 ECL model is related to how the model influences the representation of portfolio performance in the timing when the losses are recognised. The estimate of lifetime credit risk at inception would normally be included in the initial pricing of the financial asset, while 12-months ECL is recognised in the statement of profit or loss until a significant increase in credit risk is recorded. Therefore, some argue the compensation for credit risk (i.e., the interest margin) is not correctly offset by a full economic loss, causing a not faithful representation of the portfolio performance.

59 In the Endorsement Advice on IFRS 9, EFRAG considered that following the above-mentioned view, as such an approach would lead to recognising losses on creditworthy financial assets significantly in advance of both any economic losses and the compensation for credit risk that is expected to accrue throughout the life of the instrument. Moreover, EFRAG noted that the 12-months ECL allowance is intended to be a proxy for the amount of credit losses expected to be covered by interest margin over the next 12 months.

60 In addition, for some types of portfolios (i.e., retail portfolios) credit risk deterioration is not the primary element considered on determining interest margin. As an example, for large portfolios with individually insignificant and well collateralised exposures, banks would accept the same interest margin for exposures with quite significant differences in probability of default since the focus is mainly on the value of the collateral. Constituents who reported this issue noted that also for these portfolios the IFRS 9 ECL model is not reflective of the underlying performance of the portfolio; namely when a significant increase in credit risk is recorded, the cash flows resulting from the credit margin do not correctly adsorb the losses.

Exposures in stage 1 and stage 2 simultaneously *(low priority – Issue 14 – Exposures in stage 1 and stage 2 simultaneously of agenda paper 08-02)*

61 EFRAG has been informed that, because the IFRS 9 requires an entity to assess the significant increases in credit risk on an instrument-by-instrument basis, it is not uncommon for an entity to have some financial assets to be in stage 1 while other similar financial assets held by the same entity with the same counterparty to be in stage 2, depending on when such financial assets were contracted.

62 Constituents who reported this issue consider the border between the two stages unclear, especially for well collateralised exposures, so that such a presentation may be not relevant and faithful from users' perspective.

63 In the Endorsement Advice on IFRS 9, EFRAG considered that an economic assessment of initial credit loss expectations and subsequent changes in expectations provide more relevant information than an absolute assessment based on the counterparty's credit risk

level because credit risk at inception is assumed to be included in the pricing of the instrument and it is therefore the effect of the change that will result in economic losses.

Next steps

64 The EFRAG Secretariat proposes the following next steps for reaching EFRAG's final position:

8 September 2023	The EFRAG Secretariat's proposal for deadline to respond to EFRAG's DCL
8 September – 18 September 2023	Analysis of the comment letters received
21 or 22 September 2023	**EFRAG FR TEG** (additional meeting to approve the FCL) based on late papers expected to be uploaded on 18 September

Questions to EFRAG FR TEG

Questions for EFRAG FR TEG

65 Does EFRAG FR TEG agree not to report issues 5, 10, 13, and 14 to the IASB as described above?

66 Does EFRAG FR TEG agree with the drafting of the draft comment letter?

67 Does EFRAG FR TEG agree with the drafting of the cover letter to the draft comment letter?

68 Does EFRAG FR TEG agree with the timeline proposed on paragraph 64?

69 Does EFRAG FR TEG approve the DCL for publication?

Agenda Papers

70 In addition to this cover note, agenda papers for this session are:

(a) Agenda paper 04-02 – *IFRS 9 PIR Impairment – Academic input*; and

(b) Agenda paper 04-03 – *EFRAG's Draft Comment Letter.*

71 The following are links to background papers:

(a) List of PIR issues collected by the EFRAG Secretariat as preparatory work for EFRAG's Draft Comment Letter; and

(b) IASB's Request for Information on the PIR IFRS 9 Impairment.