EFRAG Secretariat: Laura Abeni, Galina Borisova, Didier Andries, Didrik Thrane-Nielsen

IFRS 9 – PIR Expected Credit Losses – initial collection of views Issues Paper

Objective

1 This paper:

(a) Describes the preliminary issues were raised following the meetings held by EFRAG Secretariat that could be part of the EFRAG's future draft comment letter in response to the forthcoming IASB PFI on IFRS 9 *Expected Credit Losses* (ECL).

(b) Ask for EFRAG TEG-CFSS members' views on these issues or any other issues which should be included into the PIR.

Information for EFRAG FR TEG-CFSS members

2 The issues described in this paper have different degree of prevalence which is not assessed at this stage. It should be noted that in deciding the issues qualifying of PIR, the IASB will consider the following questions:

(a) Is the objective of the standard met?

(b) Is the information provided useful?

(c) Is there a significant diversity in practice?

(d) Costs are significantly greater than expected?

3 The prioritisation of issues will be done based on the following assessment:

(a) Are there significant consequences?

(b) Is the issue pervasive?

(c) Should it be addressed by IASB or IFRS IC?

(d) Do benefits of action outweigh the costs?

Description of the issues

Issue 1 – Credit enhancements and financial guarantee contracts – diversity in practice

Issue 1.1 – Integral vs non-integral and way of paying the premium

4 Integral vs non-integral

(a) IFRS 9.B5.5.55 states that "*For the purposes of measuring expected credit losses, the estimate of expected cash shortfalls shall reflect the cash flows* *expected from collateral and other credit enhancements that are part of the contractual terms and are not recognised separately by the entity*...".

(b) It may be challenging interpreting what constitutes "part of the contractual terms". This was addressed by the IFRS Transition Resource Group for Impairment of Financial Instruments (ITG) at its meeting in December 2015 specifically whether the credit enhancement must be an explicit term of the related asset's contract in order for it to be taken into account in the measurement of ECL, or whether other credit enhancements that are not recognised separately can also be taken into account.

(c) However, the ITG discussion does not answer the question of how to interpret when a financial guarantee is "integral to the contractual terms" when it is not mentioned in the contractual terms of the loan.

(d) **Significant differences in practice are observed in defining whether a credit enhancement is integral or not when it is not mentioned in the contractual terms of the loan**.

5 Holder perspective

(a) If the credit enhancement is considered integral to the loan, the entity includes the cash flows expected from it in the measurement of ECL and the cost of the guarantee is treated as a transaction cost and included in the EIR. If it is assumed that the guarantee covers 100% of losses that occur on the guaranteed loan, at the loan initial recognition there are no effects in the statement of profit or loss.

(b) If the credit enhancement is required to be recognised separately by IFRS standards an entity cannot include the cash flows expected from it in the measurement of ECL. This means that the entity registers the amount of 12-months ECL in the statement of profit or loss at the loan initial recognition. For offsetting this amount, the entity should account for an asset equivalent to the 12-months ECL value, so the total amount at which the guarantee is initially recorded in the financial statement will exceed its fair value (unamortised cost equal to the premium paid plus un reimbursement asset equivalent to the 12-months ECL).

(c) In practice, **there is significant diversity if and how the 12-months ECL reimbursement asset can be recognised**. In addition, if the 12-months ECL reimbursement asset is not recognised, the accounting of integral credit enhancements and not integral credit enhancements produces different effects on the statement of profit or loss (while the economic substance is the same).

(d) Eventually, the inclusion of the guarantee cost on the EIR calculation does not seem to catch the economic substance of the credit enhancement that is to fix the amount of the loss equal to the premium paid.

6 Issuer perspective

(a) If a financial guarantee contract falls into the IFRS 9 scope, the standard require the issuer to initially record the guarantee at its fair value, and this is likely to equal the premium received. After initial recognition, the issuer shall subsequently measure it at the higher of: (i) the amount of the loss allowance determinate in accordance with the IFRS 9 requirements, and (ii) the amount initially recognised less the cumulative amount of income recognised in accordance with the principles of IFRS 15 (IFRS 9, paragraph 4.2.1).

(b) Following this accounting, the issuer recognises a credit provision only when the amortised liability value is less than the IFRS 9 ECL allowance (not IFRS 9 provisioning is recognised at the initial recognition of the financial guarantee or when the underlying asset significantly increases its credit risk). So, the statement of profit or loss figures of a financial guarantee issuer are quite different from these of a hypothetical loan issuer though the credit risk to which they are exposed is the same.

(c) In cases where the premium is paid over the time, entities should select a presentation policy to recognise or not a separate receivable for the future premiums not yet due. Based on the chosen policy, the effects deriving from the accounting of the financial guarantee might be significantly different. Following the IFRS 9, paragraph 4.2.1 rule if the issuer does not recognise the receivable, at the initial recognition of the guarantee it should record the 12-months ECL loss on the underlying asset. **It does not seem acceptable that accounting differences arise from how the premium is paid (while the economic substance is the same)**.

Questions for EFRAG FR TEG-CFSS members

7 Is this issue pervasive in Europe?

8 Do you think that it deserves the IASB activity? If yes, is standard setting, standard interpretation or educational guidance material needed?

Issue 1.2 – Joint and several guarantees

9 In some cases, multiple entities jointly and severally provide a guarantee to another entity. In calculating the cash shortfalls entities should consider the expected payments to reimburse the guaranteed amount as well as the expected reimbursements they expect to receive from each other.

10 A question arises how each guarantor should calculate ECL in their financial statements. Analysis of the legal requirements in the particular jurisdiction, the contractual agreements between the lender and the guarantors, and between the guarantors may be required to determine the rights and obligations of each party and the resulting exposure of each guarantor to expected future credit losses.

Questions for EFRAG FR TEG-CFSS members

11 Is this issue pervasive in Europe?

12 Do you think that it deserves IASB activity? If yes, is standard setting, standard interpretation or educational guidance material needed?

Issue 2 – Presentation of modification gains / losses vs impairment

13 Paragraph 82(ba) of IAS 1 *Presentation of Financial Statements* requires that the profit or loss section or the statement of profit or loss shall include as a separate line-item impairment losses (including reversals of impairment losses or impairment gains) determined in accordance with Section 5.5 of IFRS 9.

14 There are no requirements for presenting modification gains or losses as separate line item in IAS 1.

15 Paragraph 5.5.2 of IFRS 9 states that ECL includes the amounts resulting from the significant increase in credit risk due to for example modification or restructuring.

16 According to paragraph 5.4.3 of IFRS 9 "*when the contractual cash flows of a financial asset are renegotiated or otherwise modified and the renegotiation or modification does not result in the derecognition of that financial asset, an entity shall recalculate the gross carrying amount of the financial asset and shall recognise a modification gain or loss in profit or loss*".

17 Appendix A defines a modification gain or loss as the amount arising from adjusting the gross carrying amount of a financial asset to reflect the renegotiated or modified contractual cash flows.

18 **Questions arise as to how to present modification gains or losses arising from impairment of an asset which caused a modification. Can they be considered as a "realised" impairment and presented in the impairment losses (gains) line item, or should they be presented as modification gains and losses in accordance with IFRS 9?**

19 **Modifications could also be made for various reasons, and not only related to credit issues, but for example for management decisions and market conditions. Should gains or losses arising from these modifications be aggregated together in one line item or presented separately?**

Questions for EFRAG FR TEG-CFSS members

20 Is this issue pervasive in Europe?

21 Do you think that it deserves IASB activity? If yes, is standard setting, standard interpretation or educational guidance material needed?

Issue 3 – Different treatments under regulatory and IFRS 9 requirements

Issue 3.1 - Stage allocation: modification in presence of forbearance

22 In accordance with IFRS 9, when the terms of a financial asset are renegotiated or modified and this does not result in derecognition of the financial asset, then an entity recalculates the gross carrying amount of the financial asset and recognises a modification gain or loss in profit or loss. If modification results in derecognition, then a new financial asset is recognised.

At the time of modification

23 Appendix A to IFRS 9 states that: "*A financial asset is credit-impaired when one or more events that have a detrimental impact on the estimated future cash flows of that financial asset have occurred. Evidence that a financial asset is credit-impaired include observable data about the following events: … (c) the lender(s) of the borrower, for economic or contractual reasons relating to the borrower's financial difficulty, having granted to the borrower a concession(s) that the lender(s) would not otherwise consider; …*"

Potential stage classification

24 Stage 3 – In many cases, the loan will meet the definition of "credit-impaired" because the forbearance concession has only been granted due to the borrower's financial difficulty, the lender would not otherwise grant such a concession, and the concession has a detrimental effect on the estimated future cash flows (for example, a portion of the interest or principal payments are waived).

25 Stage 2 – Where the loan does not meet the definition of "credit-impaired", it should be classified in stage 2. This might be the case, for example, where a customer is not in significant financial difficulty and:

(a) a short-term payment holiday is granted where payments are only deferred (rather than waived) and interest accrues on the unpaid deferred amounts, with the result that there is not a detrimental impact on the estimated future cash flows of the loan;

(b) a loan covenant is amended or waived, which is not considered to have a detrimental impact on the estimated cash flows.

26 Stage 1 – At the time of granting a modification that is a concession to a borrower due to their financial difficulty, it would not be appropriate to classify the loan in stage 1.

27 As well as considering the ECL implications of the modification, paragraph 5.4.3 of IFRS 9 requires the gross carrying amount of the loan to be recalculated, and a corresponding modification gain / loss to be recognised in the statement of profit or loss when the contractual cash flows of a loan asset are renegotiated or otherwise modified, and this does not result in derecognition of the loan.

Subsequent classification

28 As described in paragraph B5.5.27 of IFRS 9, following such a modification a loan is not automatically considered to have lower credit risk. Typically, a borrower would need to demonstrate consistently good payment behaviour over a period of time before the credit risk is considered to have decreased and the loan moves from stage 2 to stage 1. A history of missed or incomplete payments would not typically be erased by simply making one payment on time.

29 The stage classification under IFRS 9 is a separate matter from whether or not a loan still meets a definition of "forbearance", because the latter could reflect a regulatory definition which requires a different "probation period". That is, it should not be assumed that a regulatory "probation period" can be used as the period of good payment behaviour needed to move an asset from stage 3 to stage 2, or from stage 2 to stage 1, for IFRS 9 purposes.

30 **Differences in practice are observed in applying these requirements to financial assets that are modified and those that are subject to forbearance measures.**

Questions for EFRAG FR TEG-CFSS members

31 Is this issue pervasive in Europe?

32 Do you think that it deserves IASB activity? If yes, is standard setting, standard interpretation or educational guidance material needed?

Issue 3.2 – Collective assessment of SICR: bottom-up vs top-down approach

33 Paragraph B5.5.1 of IFRS 9 states: "*in order to meet the objective of recognising lifetime expected credit losses for significant increases in credit risk since initial recognition, it may be necessary to perform the assessment of significant increases in credit risk on a collective basis by considering information that is indicative of significant increases in credit risk on, for example, a group or sub-group of financial instruments. This is to ensure that an entity meets the objective of recognising lifetime expected credit losses when there are significant increases in credit risk, even if evidence of such significant increases in credit risk at the individual instrument level is not yet available.*"

34 In the Basis for Conclusions, it is also noted (BC5.141) that financial instruments should not be grouped in order to measure ECL on a collective basis in a way that obscures significant increases in credit risk on individual financial instrument.

35 When assessing significant increases in credit risk, a top-down approach is being "promoted" from regulatory side as it results in the higher level of transfers to stage 2. However, **the sole reliance on this method for assessment of significant increases in credit risk (SICR) is considered not to be consistent with IFRS 9, as from conceptual point of view this analysis should be performed on the individual loan basis**. Entities use a bottom-up approach as they can only assess the SICR from inception at an individual instrument level.

36 **Some argue for a removal from the top-down approach from the application guidance of IFRS 9 as impracticable**.

Questions for EFRAG FR TEG-CFSS members

37 Is this issue pervasive in Europe?

38 Do you think that it deserves IASB activity? If yes, is standard setting, standard interpretation or educational guidance material needed?

Issue 3.3 – Definition of default and "prudence" layer

39 Expected credit losses are a probability-weighted estimate of credit losses over the expected life of the financial instrument (unbiased). **From a regulatory perspective prudence is being added to such an assessment. The question is raised whether the inclusion of a "prudence" layer in estimating expected credit losses is acceptable**.

40 Most banks subject to IFRS 9 are also subject to Basel III - Accord capital requirements and, to calculate credit risk-weighted assets, use either standardized or internal ratings-based approaches. The data, models, and processes used in the Basel framework can in some instances be used for IFRS 9 provision modelling, albeit with significant adjustments. As result, banks, **applying the IFRS 9 ECL model, may integrate regulatory expectations which lead to outcomes that go beyond IFRS 9 requirements**. For example, when banks have a concentrated portfolio of loans in a particular sector, it leads to higher provisions. In some cases, banks, in applying the regulatory guidelines for concentration risk, add a layer to the ECL calculation of the loans in their portfolios.

41 In addition, significant differences have been observed in the concept used for modelling the IFRS 9 PD and in the nature of adjustments applied when departing from the regulatory estimates to determine the IFRS 9 PD.

Questions for EFRAG FR TEG-CFSS members

42 Is this issue pervasive in Europe?

43 Do you think that it deserves IASB activity? If yes, is standard setting, standard interpretation or educational guidance material needed?

Issue 4 – Discount rate to be used for ECL in case the asset is floating rate based

44 The time value of money must be taken into account when calculating the ECL. The cash flows that an entity expects to receive are discounted at the effective interest rate determined at initial recognition, or an approximation thereof. If a financial instrument has a variable interest rate, ECL should be discounted using the current effective interest rate (IFRS 9, B5.5.44).

45 On the other hand, the standard permits to use forward-looking information (IFRS 9, 5.5.11) if doing so can be done without undue cost or effort. So, one could argue that instead of the current effective interest rate, one should use the forward rate.

46 **The question arises if entities can rely on forward rates to discount the expected credit loss cash flows**.

Questions for EFRAG FR TEG-CFSS members

47 Is this issue pervasive in Europe?

48 Do you think that it deserves IASB activity? If yes, is standard setting, standard interpretation or educational guidance material needed?

Issue 5 – Simplified rules for corporates

49 IFRS 9 is not solely applicable to banks, but also corporates apply the standard for their financial assets. While banks have well developed credit risk management approaches, the same is not true for many corporates. This means that corporates do not have the same level of sophistication, systems, and processes used by banks to price the financial instrument. Therefore, it is very difficult to calculate ECL at the initial recognition and during the life of the instruments.

50 Moreover, in most cases ECL mainly applies to intercompany loans on separate financial statements or financial instruments with a very high credit quality (i.e., AAA-rated bonds as investments). This results in a high level of effort and costs to calculate an expected credit loss that is ultimately immaterial.

51 **Some suggested a practical expedient for non-financial institutions to apply ECL in a simplified way. These simplified rules could be coordinated with the indications that will be developed as part of the separate financial statements project**.

Questions for EFRAG FR TEG-CFSS members

52 Is this issue pervasive in Europe?

53 Do you think that it deserves IASB activity? If yes, is standard setting, standard interpretation or educational guidance material needed?

Issue 6 – Boundary issues of ECL application to leases (IFRS IC Tentative Agenda Decision of March 2022)

Application of ECL to leases

54 Several issues are identified in this area:

(a) Exclusion of the unguaranteed residual value of the asset underlying a finance lease.

(b) Calculation of finance income from a finance lease receivable.

(c) Recognition of lease income when collectability is not probable.

(d) Whether rent concessions and forgiveness of lease payments are accounted for as a modification of IFRS 16 or write-off of the impairment allowance.

Exclusion of the unguaranteed residual value of the asset underlying a finance lease

55 The collateral considered in measuring ECL excludes any amounts attributed to the unguaranteed residual value and recorded lessor's statement of financial position. Thus, the collateral considered in the calculation of the ECL is limited to the fair value of the right of use of the asset and not to the underlying asset itself.

Calculation of finance income from a finance lease receivable

56 In the view of some the staging approach can be applied to determine how finance income recognised over the lease term is calculated:

(a) on a gross basis (excluding the effect of expected credit losses) for lease receivables in stages 1 or 2 of the ECL model; and

(b) on a net basis (based on the net investment in the lease less expected credit losses) for lease receivables in stage 3 of the ECL model.

57 This can be done through an accounting policy choice or through alternative approaches.

Recognition of lease income when collectability is not probable

58 In the view of some the lessor may recognise operating lease income even when collectability is not probable. Other approaches may also be appropriate when there is significant doubt about collectability. Diversity in practice can occur. Regardless of the approach followed IFRS 9 guidance on ECL continues to be applicable to recognised lease receivables.

Whether rent concessions and forgiveness of lease payments are accounted for as a modification of IFRS 16 or write-off of the impairment allowance

59 In accordance with paragraph 87 of IFRS 16 a lessor accounts for a modification to an operating lease as a new lease from the effective date of the modification, considering any prepaid or accrued lease payments relating to the original lease as part of the lease payments for the new lease.

60 In case the lessor forgives lease payments, in the view of some the rent concession results in a change in the consideration for the lease that was not part of the original terms of the lease and therefore may be viewed as a modification. Alternatively, the forgiveness of lease payments is seen as an extinguishment of the operating lease receivable and the derecognition requirements of IFRS 9 apply. In that case, in the view of some, the lessor has an accounting policy choice to either include or exclude the expected forgiveness of lease payments in the ECL assessment of operating lease receivables.

Determination of credit risk: IFRS IC on lease payments

61 The IFRS IC Tentative Agenda Decision of March 2022 in relation to Rent Concessions: Lessors and Lessees creates uncertainty on what the boundaries of credit risk are. In the fact pattern submitted the lessor voluntary forgives a number of lease payments to the lessee, following the closure of its retail store to comply with government restrictions. The fact pattern submitted notes that:

(a) Some lessors treat this forgiveness as a lease modification and therefore apply paragraph 87 of IFRS 16. This treatment leads to an effective allocation of the loss resulting from the rent concession over the remainder of the lease term.

(b) Other lessors, apply instead the derecognition requirements of IFRS 9 to their lease receivables in these circumstances, which results in the recognition of an immediate loss equal to the receivable's carrying amount in the period when the concession is granted.

62 The IFRS IC Tentative Agenda Decision states that: "*in the fact pattern described in the request, the lessor applies the impairment requirements in IFRS 9 to the operating lease receivable. The lessor estimates expected credit losses on the operating lease receivable by measuring any credit loss to reflect all cash shortfalls'. These shortfalls are the difference between all contractual cash flows due to the lessor in accordance with the lease contract and all the cash flows it expects to receive, determined using 'reasonable and supportable information' about 'past events, current conditions and forecasts of future economic conditions'.*

63 *Therefore, the Committee concluded that, in the period before the rent concession is granted, the lessor measures expected credit losses on the operating lease receivable in a way that reflects an unbiased and probability-weighted amount determined by evaluating a range of possible outcomes (as required by paragraph 5.5.17 of IFRS 9), including considering its expectations of forgiving lease payments recognised as part of that receivable.*"

64 The EFRAG Secretariat understands that this tentative decision raises the following issues:

(a) **The application of the ECL model to voluntarily forgiven cash flows is seen by some as extending the concept of credit loss under IFRS 9**.

(b) **There is a relation between modifications and write-offs under IFRS 9. For modifications, when adjusting the gross carrying amount of a financial asset, one shall not consider expected credit losses (except for purchased or originated credit-impaired financial assets) but one recognises a modification gain or loss (when there is no derecognition of the original financial asset)**.

Questions for EFRAG FR TEG-CFSS members

65 Is this issue pervasive in Europe?

66 Do you think that it deserves IASB activity? If yes, is standard setting, standard interpretation or educational guidance material needed?

Issue 7 – Revolving credit facilities

67 In accordance with IFRS 9, 5.5.20 an entity shall measure expected credit losses for such financial instruments over the period that the entity is exposed to credit risk and expected credit losses would not be mitigated by credit risk management actions, even if that period extends beyond the maximum contractual period.

68 IFRS 9, B5.5.39 (c) clarifies that these financial instruments are generally managed on a collective basis. These instruments are composed of a drawn amount and an undrawn commitment. To determine the period for which the entity is exposed to credit risk on these amounts, the entity should consider (IFRS 9, B5.5.40):

(a) the period over which the entity was exposed to credit risk on similar financial instruments;

(b) the length of time for related defaults to occur on similar financial instruments following a significant increase in credit risk; and

(c) the credit risk management actions that an entity expects to take once the credit risk on the financial instrument has increased, such as the reduction or removal of undrawn limits.

Scope of the exception

69 Products that are generally agreed to be in the scope of the IFRS 9, 5.5.20 exception include most credit card facilities and most retail overdrafts. What is less clear is the treatment of corporate overdrafts and similar facilities. The problem is partly that the guidance to the standard describes management on a collective basis as a characteristic that revolving facilities in the scope of the exception “generally have”, rather than a require feature as listed in IFRS 9, 5.5.20.

70 Some banks consider “management on a collective basis” is still a determining feature and that many of their corporate facilities are outside the scope of the exception because they are managed on an individual basis. Other banks consider that facilities that are individually managed are still in the scope of the exception, notably because individual credit reviews are generally performed only on an annual basis.

71 In addition, it is unclear exactly what is meant by “managed on a collective basis” and where to draw the line between large corporates and smaller entities.

Interaction with derecognition

72 The extent to which the period over which to measure ECL is restricted by the normal derecognition principles of IFRS 9 and what could constitute a derecognition of the facility.

73 It is unclear whether the existence of a contractual life and / or the lender's ability to revise the terms and conditions of the facility based on periodic credit reviews as thorough as that on origination, would be regarded as triggers for derecognition and so would also limit the life for ECL measurement. The challenge is how to determine when changes are sufficiently significant to result in a derecognition of the original facility and recognition of a new facility.

Educational video of IASB staff

74 On 16 May 2017 the IASB issued a webcast titled "*IFRS 9 Impairment: The expected life of revolving facilities*". The key messages provided were:

(a) The expected life of the portfolio will be limited by the period to the next credit review for the facilities that are expected to be cut. This because the expected life can only be reduced to the next review date to the extent that mitigation actions are expected to occur. It is not necessary to know in advance which facilities will be cut. Also the expected life of the facilities to be cut can be shorter than the time to the next review.

(b) The expected life of the remaining facilities will be bounded by when they are expected to default or to the point at which the facility is no longer used by the customer.

(c) The portfolio needs to be segmented into groups of loans with similar credit and payment expectations in order to determine its expected life.

(d) If the entity expects, based on past experience, to cut the facility only in part, by reducing the limit, then the life of the facility will be cut only for the portion of the facility that is expected to be withdrawn.

75 **The EFRAG Secretariat understands that differences in practice occur relating to how to determine the ending-point of the period over which an entity expects, in practice, to be exposed to credit risk and, consequently, to measure the ECL**.

76 The EFRAG Secretariat has been told that more guidance from the Standard is needed in order to:

(a) clarify the scope of application of the IFRS 9.5.5.20 exception with more indications on what is meant by "managed on a collective basis" and where to draw the line between large corporates and smaller entities;

(b) connect existing rules on modifications and derecognitions with the characteristics of revolving credit facilities or financial instruments composed of a drawn amount and an undrawn commitment; and

(c) include guidance and the key messages provided by the educational video in the Standard.

Questions for EFRAG FR TEG-CFSS members

77 Is this issue pervasive in Europe?

78 Do you think that it deserves IASB activity? If yes, is standard setting, standard interpretation or educational guidance material needed?

Issue 8 – Calculating ECL on intercompany loans

79 IFRS 9 requires entities to recognise expected credit losses for all financial assets held at amortised cost, including most intercompany loans from the perspective of the lender. Nevertheless, apart from a reference in IAS 27 *Separate Financial Statements*, IFRS do not explicitly deal with separate financial statements.

80 In practice, significant difficulties are observed in how calculating ECL on intercompany loans since in most cases for these loans:

(a) there is not experience of losses;

(b) a bank would never grant them without a large credit risk premium or the guarantee of a parent entity; and

(c) the maturity of the financing (especially for on-demand loans) is not in line with the expectation / intention of the parent entity. Therefore, the assessment of the subsidiary's ability to redeem the loan would not provide the right reflection of the parent's intention and the expected cash flows.

81 Finally, parent company generally avoids losses on intercompany loans by providing for capital injections.

82 **Some advocate for the removal of intercompany loans from the application of general IFRS ECL model and its replacement with an incurred loss model, accompanied by a strengthening of the disclosure on related party transactions**.

Questions for EFRAG FR TEG-CFSS members

83 Is this issue pervasive in Europe?

84 Do you think that it deserves IASB activity? If yes, is standard setting, standard interpretation or educational guidance material needed?

Issue 9 – Contractually Linked Instruments (CLI and SPEs investments) – definition of default

85 Some CLIs that are more senior tranches may pass the SPPI test and consequently will be measured at amortised cost or fair value through other comprehensive income.

86 Appendix A of IFRS 9 defines "credit loss" as "*the difference between all contractual cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive (i.e., reflecting any cash shortfalls), discounted at the original effective interest rate*".

87 Due to a pre-defined waterfall structure, the issuer of a CLI only passes on cash flows that it actually receives, so the contractually defined cash flows under the waterfall structure (i.e., principal and interest are first paid on the most senior tranche and then successively paid on more junior tranches) are always equal to the cash flows that a holder expects to receive. Following this argument, one could argue that CLIs never give rise to a credit loss, and so would never be regarded as impaired.

88 A different view states that IFRS 9 deems certain tranches of credit linked instruments (CLIs) to satisfy the SPPI criterion (the contractual terms of the CLI are 'deemed' to give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding). Consequently, the holder of a CLI tranche needs to consider the 'deemed' principal and interest payments as the contractual cash flows, instead of the contractual cash flows determined under the waterfall structure, for the purposes of the effective interest method and impairment requirements of IFRS 9. Accordingly, any failure of the instrument to pay the investor the full amount deemed to be due must be treated as a default and an estimation of the amount of any losses that will be incurred must be reflected in the credit loss allowance.

89 **The EFRAG Secretariat has been informed that more guidance on when a CLI should be considered in default would be appropriate.**

Questions for EFRAG FR TEG-CFSS members

90 Is this issue pervasive in Europe?

91 Do you think that it deserves IASB activity? If yes, is standard setting, standard interpretation or educational guidance material needed?

Issue 10 – Timing to move to stage 3 (next reporting date or during the reporting period)

92 Paragraph 5.5.3 of IFRS 9 requires an entity to measure at each reporting date, the loss allowance for a financial instrument at an amount equal to the lifetime expected credit losses if the credit risk on that financial instrument has increased significantly since initial recognition (stage 2). The EIR for assets which are not credit-impaired is applied to the gross carrying amount of the financial asset (paragraph 5.4.1).

93 According to paragraph B5.5.33 when a financial becomes credit-impaired, 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. Any adjustment is recognised in profit or loss as an impairment gain or loss. For such assets the EIR is applied to the amortised cost of the financial asset in subsequent reporting periods.

94 **The EFRAG Secretariat understands that differences in practice occur relating to the timing of move of a financial asset to stage 3. In some cases, the financial asset is moved to stage 3 as from the next reporting date, in other cases this is done during the ongoing reporting period**.

95 Some suggested a practical expedient to apply the EIR on a net basis starting from a next reporting period.

Questions for EFRAG FR TEG-CFSS members

96 Is this issue pervasive in Europe?

97 Do you think that it deserves IASB activity? If yes, is standard setting, standard interpretation or educational guidance material needed?

Issue 11 – Write-offs – diversity in practice

98 **It is noted that currently there is significant diversity in practice in applying write-offs.** In case the ECL covers 95% of the exposure, the remaining 5% of the exposure is often not reported. It is questioned whether this should be reported as a derecognition loss. Accounting for this amount into an allowance account is not considered useful.

99 **The requirement "has no reasonable expectation of recovering" in IFRS 9, paragraph 5.4.4 needs further application guidance.**

Questions for EFRAG FR TEG-CFSS members

100 Is this issue pervasive in Europe?

101 Do you think that it deserves IASB activity? If yes, is standard setting, standard interpretation or educational guidance material needed?

Issue 12 – Reliability of forward-looking information

102 In the event of major crises, the use of forward-looking information requires judgment. The use of forward-looking information is useful only to the extent it is reliable. Therefore, **some consider more emphasis should be put on the reliability of the information**.

103 IFRS 7, paragraph 35H requires a reconciliation from the opening balance to the closing balance of the loss allowance. For lifetime expected credit losses, it is suggested to breakdown the allowance further between those amounts that relate to expected credit losses that are expected to occur:

(a) within one year;

(b) beyond one year.

104 **In addition to this a back testing for this roll-over should be added.**

Questions for EFRAG FR TEG-CFSS members

105 Is this issue pervasive in Europe?

106 Do you think that it deserves IASB activity? If yes, is standard setting, standard interpretation or educational guidance material needed?

Issue 13 – Interaction between derecognition and staging

107 It is noted that the accounting for loan restructurings in case of difficulties of the debtor (i.e., Covid) are unclear. In particular, the derecognition requirements for financial assets in IFRS 9 lack clarity on how to apply them to loans being restructured. In case lifetime expected losses are applied to a loan that is restructured, and the subsequent change in contract characteristics leads to derecognition then the new loan is being recognised with a 12-months ECL allowance. **This decrease in impairment allowance from lifetime to 12-months is counterintuitive to the underlying economics (i.e., the deteriorating economics that lead to a restructuring)**.

108 While the restructured loan is initially being recognised at fair value (IFRS 9, paragraph 5.1.1), however that fair value is often not observable and thus provides no balance to the removal of the lifetime ECL allowance.

109 In case the restructuring of the loan leads to an originated credit-impaired financial asset (POCI) then the previous lifetime impairment allowance is removed while no new allowance is recognised (in accordance with IFRS 9 paragraph 5.5.13 the entity shall only recognise the cumulative changes in lifetime expected credit losses since initial recognition).

Questions for EFRAG FR TEG-CFSS members

110 Is this issue pervasive in Europe?

111 Do you think that it deserves IASB activity? If yes, is standard setting, standard interpretation or educational guidance material needed?

Issue 14 – Purchased or credit-impaired financial assets (POCI), alternative treatment of ECL

112 In practice, it is noticed that the POCI category is only used by banks that have a business in this area (as well the systems to support this business, such as management of junk bonds). In other situations, where the management of POCI financial assets is not a core business, the supporting IT systems seem to be often lacking.

113 In the view of some, the scope of the POCI category is to be reassessed. The current POCI requirements are considered to be appropriate for banks that have the management of these financial assets as a core business. **In other cases, for example where the occurrence of POCI financial assets is accidental to the business model, it is argued by some that an alternative treatment for ECL recognition should be applied** (i.e., an entity should recognise an impairment allowance in accordance with stage 2 immediately).

Questions for EFRAG FR TEG-CFSS members

114 Is this issue pervasive in Europe?

115 Do you think that it deserves IASB activity? If yes, is standard setting, standard interpretation or educational guidance material needed?

Issue 15 – Procyclicality of IFRS 9 ECL model

116 Recalling the concept of "procyclicality" considered by IASB on writing the IFRS 9 Standard[1], one concern arising from discussions is related to the effectiveness of the ECL model to address the criticism of "too little, too late". Anticipating a significant deterioration of credit conditions as a consequence of including forward-looking information on the ECL calculation, banks would be forced to increase provisions. This would result in lower earnings, lower capital rations, and credit contraction at the moment when lending is most needed. This becomes even more evident during the COVID-19 pandemic where regulatory institutions intervened for avoiding that an excessively rigorous application of the accounting rules could generate pro-cyclical effects and therefore jeopardize the support measures for businesses, launched by the various national governments during the first half of the year of 2020.

117 In addition, the use of a probability of default base on a point-in-time perspective may result in higher volatility in the ECL amount recognised in profit or loss as provisions increase when economic conditions deteriorate and decrease when economic conditions improve. As a result, if many banks face the pressure of expected loss and decreasing profitability simultaneously in an economic downturn, they may deleverage and reduce credit supply at the same time, with may exacerbate the downturn. Lastly, earnings volatility generally has a negative impact on banks value and share price and is considered a proxy for business risk that may also exacerbate the downturn.

118 **In the short term, the concern has changed from "too little, too late" to "too much, too soon"**.

Questions for EFRAG FR TEG-CFSS members

119 Is this issue pervasive in Europe?

120 Do you think that it deserves IASB activity? If yes, is standard setting, standard interpretation or educational guidance material needed?

Issue 16 – Portfolios of high credit quality exposures

121 During the discussions, the following points arose:

(a) **The intrinsic characteristics of large high quality credit exposures suggest that for those exposures the most representative approach for impairment losses is either a single amount or a best estimate from a range of possible amounts** (IAS 39 approach). This approach seems to be more appropriate to reflect the real credit risk on financial statements (instead of the "probability-weighted amounts" IFRS 9 approach). This suggested solution could also prevent the use of significant model adjustment saw in practices due to significant subjectivity inherent in estimating credit losses and to the lack of relevance of using expected value models for these exposures.

[1] In this case, procyclicality is the idea that the banking sector, through a variety of channels or 'causal' links with the real economy, can exacerbate economic cycles, leading to excessive economic growth during upturns and deeper recessions in the downturns.

(b) Connected with the previous point, **in some cases a reversal of impairment was observed for very well collateralised exposures that move from stage 2 to stage 3**. This phenomenon is considered evidence that the IFRS 9 ECL model does not depict the real credit risk in the best way possible for these exposures.

(c) The recognise of the "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 by the users' perspective, in addition to causing unjustified efforts and costs on application phases. **A suggestion is made to exempt these exposures from day one ECL provisioning**.

Questions for EFRAG FR TEG-CFSS members

122 Is this issue pervasive in Europe?

123 Do you think that it deserves IASB activity? If yes, is standard setting, standard interpretation or educational guidance material needed?

Issue 17 – Credit risk and portfolio performance

124 One criticism to the IFRS 9 ECL model is related to **how the model influences the representation of portfolios 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 that 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.

125 This issue was discussed during the IFRS 9 endorsement process, and 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 (Endorsement Advice on IFRS 9 Financial Instruments, paragraph 68). Moreover, EFRAG noted that the 12-months ECL loss allowance amount is intended to be a proxy for the amount of credit losses expected to be covered by interest margin over the next 12 months (Endorsement Advice on IFRS 9 Financial Instruments, paragraph 21(a)).

126 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 irrelevant 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. During the discussions, **it was 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**.

Questions for EFRAG FR TEG-CFSS members

127 Is this issue pervasive in Europe?

128 Do you think that it deserves IASB activity? If yes, is standard setting, standard interpretation or educational guidance material needed?

Issue 18 – Exposures in stage 1 and stage 2 simultaneously

129 Because the IFRS 9 requires to assess the significant increases in credit risk on instrument-by-instrument basis, it is not uncommon for financial assets with the same counterparty to be both in stage 1 and stage 2, depending on when such financial assets were contracted. **The border between the two stages is considered unclear, especially for well collateralised exposures, so that such a presentation may be not relevant and faithful from users' perspective**.

130 This point of view was also discussed during the IFRS 9 endorsement process, and 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 (Endorsement Advice on IFRS 9 Financial Instruments, paragraph 78).

Questions for EFRAG FR TEG-CFSS members

131 Is this issue pervasive in Europe?

132 Do you think that it deserves IASB activity? If yes, is standard setting, standard interpretation or educational guidance material needed?

Issue 19 – Understandability and comparability of disclosures

Issue 19.1 – ECL numbers difficult to compare

133 The forward-looking approach in the expected credit losses model requires the application of judgement. The judgements and estimates will be based on multiple sources of information combining internal and external data including forward-looking and macroeconomic information which is available on a reasonable and supportable basis. Further, IFRS 9 also includes practical expedients for implementing the impairment model[2].

134 **It was observed that the high level of judgment embedded in the standard keeps it open to a wide variety of practices and no single practice appears to be a strong driver of the ultimate levels of provisioning**. Moreover, the judgment involved in ECL calculation allows for different degrees of prudence since it was noted that strong banks may have more prudent ECL figures compared to weaker banks.

135 Lastly, **it was noted that the level of disclosures provided was not always sufficient to compensate the high levels of uncertainty arising from the level of judgement required by IFRS 9 for recognition of expected credit losses**.

Questions for EFRAG FR TEG-CFSS members

136 Is this issue pervasive in Europe?

137 Do you think that it deserves IASB activity? If yes, is standard setting, standard interpretation or educational guidance material needed?

[2] IFRS 9 includes the following practical expedients:

(a) When assessing significant increases in credit risk:
  i. more than 30 days past due rebuttable presumption;
  ii. the assessment can be based on 12-months rather than lifetime probabilities of default;
  iii. entities can compare current credit risk with threshold for credit risk at origination; and
  iv. entities can perform the assessment at counterparty rather than at individual instrument level.

(b) IFRS 9 permits 12-months expected credit losses to be recognised irrespective of the change in credit risk from initial recognition provided that the financial asset's credit risk is assessed as low at the reporting date.

(c) When calculating expected credit losses entities can apply practical expedients which are compliant with the general requirements for measurement of expected credit losses.

Issue 19.2 – Disclosures – Diversity in practice

138 Based on IFRS 7, paragraph 35G, an entity shall explain the inputs, assumptions and estimation techniques used to apply the requirements in Section 5.5 of IFRS 9.

139 Although formally compliant with IFRS 7 requirements, **the banks' ECL disclosures were hardly comparable**. From the discussions, it came to light that analysis of banks credit risk disclosures showed a significant diversity in practice with different level of detail about the assumptions taken and methodologies applied. It was also noted that often **the disclosures were not clear enough on how the ECL figures were derived and excessively influenced by the regulatory framework in each country**.

140 The EFRAG Secretariat has been informed that more guidance on disclosures would be appropriate.

Questions for EFRAG FR TEG-CFSS members

141 Is this issue pervasive in Europe?

142 Do you think that it deserves IASB activity? If yes, is standard setting, standard interpretation or educational guidance material needed?