EFRAG Secretariat: Laura Abeni, 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 – Prioritisation of issues - Issues Paper

Objective

1 The objective of this paper is to categorise and prioritise the issues collected during the preliminary work performed by the EFRAG Secretariat in anticipation of the publication of RFI of the PIR of IFRS 9 – *Impairment*.

2 The preliminary categorisation in this paper is presented for discussion and to collect EFRAG FR TEG members' views on pervasiveness and prevalence of the issues in Europe.

Criterion

3 To prioritise the issues, the EFRAG Secretariat has considered the following questions:

(a) Are there fundamental questions (i.e., 'fatal flaws') on the clarity and suitability of the core objectives or principles in the impairment requirements?

(i) Do the requirements achieve its objective of providing useful information about changes in credit risk and timely recognition of expected credit losses?

(ii) Have the requirements resolved the issues they were designed to address?

(b) Are the benefits to users of financial statements arising from applying the requirements significantly lower than expected?

(i) Is the resulting information useful to users?

(ii) Are the requirements and application guidance capable of being applied consistently?

(iii) If diversity in practice exists, what is the cause and what is the effect?

(c) Are the costs of applying some or all of the requirements and auditing and enforcing their application significantly greater than expected?

(i) Do actual effects differ from the expected effects set out in the Effects Analysis?

(ii) Have there been any significant effects (positive or negative) that were not identified in the Effects Analysis?

(iii) Is there a significant market development since requirements were issued causing diversity in practice?

Summary

4 The following table – in the columns "*IASB Category*", "*Criterion*", "*Prevalence in Europe*", and "*Priority in Europe*" – contains **the EFRAG Secretariat's preliminary assessment** to be confirmed by EFRAG FR TEG.

5 Please, note that EFRAG Secretariat has highlighted the presence of any comments made by EFRAG FIWG and IAWG in the column "*EFRAG FIWG and IAWG comments*". The detailed comments received from EFRAG FIWG and IAWG members are reported in paragraph 198 *et seq*.

#	Issue	IASB Category	Criterion	Prevalence in Europe	Priority in Europe	EFRAG FIWG and IAWG comments
1.1	Integral vs non-integral and way of paying the premium	Loan commitments and financial guarantees	Requirements and application guidance difficult to be applied consistently	Prevalent	Medium	See par. 200
1.2	Joint and several guarantees	Loan commitments and financial guarantees	Diversity in practice	Some prevalence	Medium	See par. 201
2	Presentation of modification gains / losses vs impairment	Other topics	Requirements and application guidance difficult to be applied consistently	Prevalent	High	See par. 202
3.1	Stage allocation: modification in presence of forbearance	Determining significant increases in credit risk	Diversity in practice	Prevalent	Low	See par. 203
3.2	Collective assessment of SICR: bottom-up vs top-down approach	Determining significant increases in credit risk	Wording not entirely consistent within the Standard	Some prevalence	Low	See par. 204
3.3	Definition of default and "prudence" layer	General approach to impairment	Requirements and application guidance difficult to be applied consistently	Prevalent	Low	See par. 205
4	Discount rate to be used for ECL in case the asset is floating rate based	Measurement of ECL	Diversity in practice	Some prevalence	Low	See par. 206
5	Simplified rules for corporates	Simplified approach for trade in lease receivables	Requirements and application guidance difficult to be applied consistently	Not prevalent	Low	See par. 220
6.1	Application of ECL to lease receivables	General approach to impairment	Diversity in practice	Prevalent	Medium	No comments

6.2	Determination of credit risk	General approach to impairment	Diversity in practice	Prevalent	High	See par. 207
7.1	Revolving credit facilities – Scope of the exception	Measurement of ECL	Diversity in practice	Prevalent	Medium	See par. 208
7.2	Revolving credit facilities – Interaction with derecognition	Measurement of ECL	Diversity in practice	Prevalent	Medium	See par. 208
7.3	Revolving credit facilities – Educational video of IASB Staff	Measurement of ECL	Diversity in practice	Prevalent	Medium	See par. 208
8	Calculating ECL on intragroup loans	Measurement of ECL	Requirements and application guidance difficult to be applied consistently	Prevalent	Low	See par. 209
9	Contractually Linked Instruments (CLI and SPEs investments) – definition of default	Measurement of ECL	Requirements and application guidance difficult to be applied consistently	Prevalent	Medium	No comments
10	Timing to move to stage 3 (next reporting date or during the reporting period)	Other topics	Diversity in practice	Not prevalent	Low	No comments
11	Write-offs – diversity in practice	Other topics	Diversity in practice	Prevalent	Low	See par. 210
12	Reliability of forward-looking information	General approach to impairment	Requirements and application guidance difficult to be applied consistently	Not prevalent	Low	No comments
13	Interaction between derecognition and ECL amounts	General approach to impairment	Diversity in practice	Some prevalence	Low	See pars. 211 and 212
14	Purchased or credit-impaired financial assets (POCI), alternative treatment of ECL	Credit-impaired assets on initial recognition	Requirements not working as intended	Some prevalence	Low	See par. 213
15	Procyclicality of IFRS 9 ECL model	General approach to impairment	Requirements not working as intended	Not prevalent	Low	See pars. 214, 215 and 221

16	Portfolios of high credit quality exposures	General approach to impairment	Requirements not working as intended	Not prevalent	Low	See pars. 216 and 222
17	Credit risk and portfolio performance	General approach to impairment	Requirements not working as intended	Not prevalent	Low	No comments
18	Exposures in stage 1 and stage 2 simultaneously	General approach to impairment	Requirements not working as intended	Not prevalent	Low	No comments
19.1	Low comparability of the ECL numbers	Disclosures	Diversity in practice	Prevalent	High	See par. 217
19.2	Comparability of disclosures	Disclosures	Diversity in practice	Prevalent	High	No comments
20	Impact of climate-related risk factors (new)	Measurement of ECL	Requirements and application guidance difficult to be applied consistently	Prevalent	Medium	No comments

Assessment 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

Integral vs non-integral

6 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...".*

7 It may be challenging to interpret what constitutes *"part of the contractual terms"*. This issue was addressed by the IFRS Transition Resource Group for Impairment of Financial Instruments (ITG) at its meeting in December 2015, more 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.

8 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.

9 **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**.

Holder perspective

10 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 effectively 100% of losses that occur on the guaranteed loan, at the initial recognition of the loan there are no (neglectable) effects in the statement of profit or loss.

11 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 recognises the amount of 12-months ECL in the statement of profit or loss at the initial recognition of the loan. To offset this amount, the entity may choose to book an asset equivalent to the 12-months ECL value, so the total amount at which the guarantee is initially recorded in the financial statements will exceed the fair value of the guarantee (amortised cost equals to the premium paid plus a reimbursement asset equivalent to the 12-months ECL).

12 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).

13 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.

<u>Issuer perspective</u>

14 If a financial guarantee contract falls into the IFRS 9 scope, the standard requires the issuer to initially record the guarantee at its fair value, and this is likely to be equal to the premium received. After initial recognition, the issuer shall subsequently measure it at the higher of: (i) the amount of the loss allowance determined 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(c)).

15 Applying the above, the issuer recognises a credit provision only when the amortised cost of a liability is less than the IFRS 9 ECL allowance (no IFRS 9 provisioning is recognised at initial recognition of the financial guarantee but when the credit risk of the underlying asset increases significantly). So, the impact on the profit or loss for the issuer of a financial guarantee is quite different from a hypothetical loan issuer though the credit risk to which they both are exposed is the same.

16 In cases where the premium is paid over time, entities should select a presentation policy to recognise or not a separate receivable for the future premiums not yet due taking into account implied options. Based on the chosen policy, the impacts of the accounting for the financial guarantee might be significantly different. According to paragraph 4.2.1(c) of the IFRS 9, if the issuer does not recognise the receivable, at initial recognition of the guarantee it should record the 12-months ECL on the underlying (premium receivable) asset. **Therefore, the accounting differences arise depending on how the premium is paid (while the economic substance is the same)**.

Prevalence in Europe

17 The feedback received during the EFRAG Secretariat preliminary work highlighted that the use of credit enhancements and financial guarantee contracts is widespread and increasing in Europe.

Priority in Europe

18 The EFRAG Secretariat notes:

(a) from a holder perspective, when a financial guarantee is not included in the contractual terms of the debt instrument, significant judgement is required to assess whether the financial guarantee is an integral part of the financial

instrument. Considering that different conclusions could lead to different accounting effects, further application guidance on this aspect is needed;

(b) from an issuer perspective, the accounting differences based on the payment methods of the premium received (one-time or over time) may not provide useful information to users of financial statements as the risks to which the issuer is exposed are the same in both cases.

19 Therefore, this topic is considered as medium priority by the EFRAG Secretariat.

IASB Category	Loan commitments and financial guarantees
Criterion	Requirements and application guidance difficult to be applied consistently
Prevalence in Europe	Prevalent
Priority in Europe	Medium

Issue 1.2 – Joint and several guarantees

20 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 reimbursements they expect to receive from each other.

21 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.

Prevalence in Europe

22 The feedback received during the EFRAG Secretariat preliminary work highlighted that this issue has some prevalence in Europe.

Priority in Europe

23 The EFRAG Secretariat considers that the IASB could provide guidance on measuring obligations under joint and several guarantee arrangement, both initially and in subsequent periods. Therefore, this topic is considered as medium priority by the EFRAG Secretariat.

IASB Category	Loan commitments and financial guarantees
Criterion	Diversity in practice
Prevalence in Europe	Some prevalence
Priority in Europe	Medium

Issue 2 – Presentation of modification gains / losses vs impairment

24 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.

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

26 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.

27 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*".

28 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.

29 **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?**

30 **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?**

Prevalence in Europe

31 The feedback received during the EFRAG Secretariat preliminary work highlighted that this issue is prevalent in Europe.

Priority in Europe

32 In the view of the EFRAG Secretariat, in general, the interaction between modification, impairment, and derecognition requirements needs clarification. The allocation of the accounting effects to the three events (and the consequent presentation in the statement of profit or loss) depends on several factors and interpretations (e.g., the reason that causes the modification and/or the derecognition – commercial opportunities, financial difficulties of the borrower – or the order in which an entity considers the different elements).

33 The need for clarification on the interaction between modification, impairment, and derecognition requirements is also highlighted by the existence of several individually not relevant issues touching different aspects of this interaction (e.g., issues 3.1, 11, and 13).

34 Therefore, this topic is considered as high priority by the EFRAG Secretariat.

IASB Category	Other topics
Criterion	Requirements and application guidance difficult to be applied consistently
Prevalence in Europe	Prevalent
Priority in Europe	High

Issue 3 – Different treatments under regulatory and IFRS 9 requirements

Issue 3.1 – Stage allocation: modification in presence of forbearance

35 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

36 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

37 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).

38 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.

39 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.

40 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

41 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.

42 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.

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

Prevalence in Europe

44 The feedback received during the EFRAG Secretariat preliminary work highlighted that this issue is prevalent in Europe.

Priority in Europe

45 In the view of the EFRAG Secretariat, the "prohibition period" applied to assess when to move an asset from stage 3 to stage 2, or from stage 2 to stage 1, should be determined on an entity-by-entity basis depending on the characteristics of the asset and the reference market. A general rule would hardly adapt to different contexts and situations. Therefore, the EFRAG Secretariat notes that this element could be considered for the improvement of ECLs disclosures (see issues 19.1 and 19.2) and for the clarification on the interaction between modification, impairment, and derecognition (see issue 2).

46 This topic is considered as low priority by the EFRAG Secretariat.

IASB Category	Determining significant increases in credit risk
Criterion	Diversity in practice
Prevalence in Europe	Prevalent
Priority in Europe	Low

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

47 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.*"

48 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.

49 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.

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

Prevalence in Europe

51 The monitoring report "IFRS 9 Implementation by EU Institutions" published by EBA in November 2021 highlighted that the use of the top-down approach in Europe is limited and financial institutions generally prefer to use a combination of bottom-up and top-down approaches.

Priority in Europe

52 The introduction of a collective assessment for financial assets addressed the concerns that banks may have a very large number of small exposures managed on an aggregated basis. Much of the information to monitor them is a combination of past due and behavioural data with historical statistical experience and macroeconomics indicators.

53 Because of several difficulties to apply the top-down approach as described in IFRS 9.IE39 Illustrative Example 5 – Region Three (e.g., how to calculate the percentage of loans that have significantly deteriorated), banks usually prefer to first allocate exposure to stage 2 based on an individual assessment and then to apply a collective approach to the remaining stage 1 exposures.

54 Nevertheless, the EFRAG Secretariat notes that top-down collective assessment is one of the possibilities for entities to appropriately adjust ratings and PDs to reflect changes in credit quality not yet detected at an individual level, giving the IFRS 9 ECL model appropriate flexibility to be adapted to different contexts and situations. Therefore, the EFRAG Secretariat considers that this approach should be maintained by the IASB.

55 Instead, the EFRAG Secretariat would suggest a revision of language as to when a collective approach is required, as it is not entirely consistent within the Standard.

56 Paragraph B5.5.1 of IFRS 9 states that "*it **may be necessary** to perform the assessment*" (emphasis added) on a collective basis, which is consistent with the requirements in paragraph 5.5.11, that "*an entity cannot rely solely on past due information if reasonable and supportable forward-looking information is available without undue cost and effort*".

57 However, paragraph B5.5.4 states that if *"an entity does not have reasonable and supportable information that is available without undue cost or effort to measure lifetime expected credit losses on an individual instrument basis… lifetime expected credit losses **shall be** recognised on a collective basis that considers comprehensive credit risk information"* (emphasis added). This "**shall be**" wording could be interpretated as not entirely consistent with the "**may be**" wording in paragraph B.5.5.1.

58 This topic is considered as low priority by the EFRAG Secretariat.

IASB Category	Determining significant increases in credit risk
Criterion	Wording not entirely consistent within the Standard
Prevalence in Europe	Some prevalence
Priority in Europe	Low

Issue 3.3 – Definition of default and "prudence" layer

59 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**.

60 Most banks subject to IFRS 9 are also subject to Basel III framework for capital requirements and, to calculate credit risk-weighted assets, use either standardised 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 a 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.

61 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.

Prevalence in Europe

62 The feedback received during the EFRAG Secretariat preliminary work highlighted that this issue is prevalent in Europe due to the fact that judgment embedded in the ECL calculation allows for different degrees of prudence.

Priority in Europe

63 When developing the ECL requirements, the IASB decided not to specifically define default in IFRS 9. Because of the various interpretation of default, the IASB was concerned that defining it could result in a definition for financial reporting that is inconsistent with that applied internally for credit risk management. That could result in the impairment model being applied in a way that does not provide useful information about actual credit risk management (Bases for Conclusions of IFRS 9, paragraphs BC5.251 and BC5.252).

64 The EFRAG Secretariat considers that IASB considerations are still valid and that the ECL model should be aligned with the internal credit risk management practices to provide useful information within the boundaries of the Standard.

65 However, the EFRAG Secretariat notes the concept used for modelling the IFRS 9 PD and the description of the nature of adjustments applied could be considered as element for the improvement of ECLs disclosures (see issues 19.1 and 19.2).

66 This topic is considered as low priority by the EFRAG Secretariat.

IASB Category	General approach to impairment
Criterion	Requirements and application guidance difficult to be applied consistently
Prevalence in Europe	Prevalent
Priority in Europe	Low

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

67 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 when a financial instrument has a variable interest rate, the current effective interest rate is determined in accordance with paragraph B5.4.5 (IFRS 9, Appendix A and B5.5.44).

68 For the calculation of effective interest rate for financial instruments with variable interest rate, either the spot or the forward rate at the reporting date could be used under IFRS 9. The standard requires to use forward-looking information (IFRS 9, 5.5.11) in ECL calculations 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.

69 **The question arises if entities may or must rely on forward rates to discount the expected credit loss cash flows**.

Relevant IFRS requirements

70 For financial assets that are not purchased or originated credit-impaired financial asset effective interest rate is used to calculate gross carrying amount and expected credit losses (IFRS 9.5.4.1 and IFRS 9.B5.5.44).

71 When calculating the effective interest rate, an entity shall estimate the expected cash flows by considering all the contractual terms of the financial instrument but shall not consider the expected credit losses (IFRS 9 Appendix A).

72 For floating-rate financial instruments periodic re-estimation of cash flows to reflect the movements in the market rates of interest alters the effective interest rate (IFRS 9.B5.4.5).

73 Expected credit losses shall be discounted to the reporting date using the effective interest rate determined at initial recognition or an approximation thereof. If a financial instrument has a variable interest rate, expected credit losses shall be discounted using the current effective interest rate determined in accordance with paragraph B5.4.5 (IFRS 9.B5.5.44).

74 IFRS 9 is thus clear that it is the same effective interest rate that is used when calculating gross carrying amount and expected credit losses.

75 On 11 December 2015, the IFRS Transition Resource Group for Impairment of Financial Instruments ('ITG') discussed, among other things, the meaning of "current effective interest rate" related to the appropriate discount rate to use when measuring ECLs for a floating rate financial assets.

76 During the discussion it was noted that:

(a) either the spot or the forward rate at the reporting date could be used under IFRS 9;

(b) the rate used should be applied consistently for forecasting the contractual cash flows, forecasting the cash shortfalls, discontinuing the cash flows and revenue recognition;

(c) the notion of effective interest rate and the meaning of "current interest rate" under IFRS 9 has not changed from IAS 39 *Financial Instruments: Recognition and Measurement*.

Issue raised

77 It is the understanding of the EFRAG Secretariat that the question at hand is initiated by the fact that a large number of entities when calculating the effective interest rate is using the current spot market rate, as opposed to the current forward market rate, when estimating future cash flows on floating-rate financial instrument. Since the re-estimation of the future interest payments on a floating-rate financial instruments normally has no significant effect on the carrying amount of the financial instrument, this practice has widespread acceptance.

Prevalence in Europe

78 It is the understanding of the EFRAG Secretariat that although for floating-rate financial instruments there may be diversity in practice on the use of current spot market rate or forward market rate when estimating future cash flows used in the calculation of effective interest, European entities generally apply either of the approaches consistently, that is entities use the same effective interest for the calculation of gross carrying amount (of interest income) and expected credit loss. The EFRAG Secretariat considers that this issue has some prevalence in Europe.

Priority in Europe

79 The EFRAG Secretariat notes that the solution to the issue raised relates to a clarification of the effective interest rate method when it comes to floating-rate financial instruments rather than a clarification of the impairment requirements in IFRS 9. The EFRAG Secretariat notes that IASB through the Post-implementation Review of IFRS 9—*Classification and Measurement* has initiated an *Amortised Cost Measurement* project that is currently a part of the research project pipeline. It is

expected that the application of paragraph B5.4.5 will be covered in the *Amortised Cost Measurement* project.

80 A clarification of the effective interest rate method when it comes to floating-rate financial instruments my result in a large number of European entities being exposed to a requirement to change a practice that normally has no significant effect on the carrying amount of the financial instrument.

81 The EFRAG Secretariat has identified this as a low priority issue.

IASB Category	Measurement of ECL
Criterion	Diversity in practice
Prevalence in Europe	Some prevalence
Priority in Europe	Low

Issue 5 – Simplified rules for corporates (see also Issue 8)

82 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 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 were issued to non-listed entities.

83 Moreover, in most cases ECL mainly applies to intercompany loans in separate financial statements or to 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.

84 **Some suggested a practical expedient for corporates 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**.

Prevalence in Europe

85 This is the EFRAG Secretariat understanding that this issue has low prevalence in Europe.

Priority in Europe

86 There are already some practical expedients for trade and lease receivables which can be applied by corporates. Corporates having significant financial instruments balances are presumed to have adequate credit risk management policies and processes enabling them to calculate ECL. In addition, providing the exception from general rules for corporates might have negative impact on comparability of financial statements. Based on the above, this issue is considered to be low priority by the EFRAG Secretariat.

IASB Category	Simplified approach for trade and lease receivables
Criterion	Requirements and application guidance difficult to be applied consistently
Prevalence in Europe	Not prevalent
Priority in Europe	Low

Issue 6 – Boundary issues of ECL application

Issue 6.1 – Application of ECL to lease receivables

87 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; and

(d) Whether rent concessions and forgiveness of lease payments are accounted for as a modification in IFRS 16 or a derecognition in IFRS 9.

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

88 The collateral considered in measuring ECL excludes any amounts attributed to the unguaranteed residual value and recorded in the 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 fair value of the underlying asset itself.

Calculation of finance income from a finance lease receivable

89 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.

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

Recognition of lease income when collectability is not probable

91 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 a derecognition in IFRS 9

92 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.

93 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.

94 The IFRS IC Agenda Decision approved in October 2022 (the "AD") *Lessor Forgiveness of Lease Payments (IFRS 9 and IFRS 16)* 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.

95 The IFRS IC 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'.*

96 *Therefore, the Committee concluded that, 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 …', 'the time value of money', and 'reasonable and supportable information …' (as required by paragraph 5.5.17 of IFRS 9). This measurement of expected credit losses includes the lessor considering its expectations of forgiving lease payments recognised as part of that receivable.*"

97 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)**.

Prevalence in Europe

98 The feedback received during the EFRAG Secretariat preliminary work highlighted that these issues are prevalent in Europe.

Priority in Europe

99 The EFRAG Secretariat considers that the IASB could provide guidance on issues that have arisen in practice in relation to IFRS 16 and IFRS 9 impairment requirements. Therefore, this topic is considered as medium priority by the EFRAG Secretariat.

IASB Category	General approach to impairment
Criterion	Diversity in practice
Prevalence in Europe	Prevalent
Priority in Europe	Medium

Issue 6.2 – Determination of credit risk

100 The EFRAG Secretariat understands that the AD, as worded with reference to **"all cash shortfalls"**, could have broader impacts as the comment letters received by the IFRS IC demonstrated that there is a diversity in practice on whether to restrict the cash shortfalls used to measure ECLs on financial assets to those arising from the counterparty's credit situation (and thus, ignoring shortfalls arising from the entity's decision to waive cash flows for reasons other than credit risk).

101 In many cases, the definition of "credit loss" in IFRS 9 Appendix A refers to "all cash shortfalls" has been read in conjunction with the general principles of IFRS 9 where ECL is calculated with reference to exposure to credit risk defined by reference to the risk of a default occurring. Therefore, the expression "all cash shortfalls" has been interpreted within the scope of concessions from the lender due to financial difficulties of the borrower.

102 On the contrary, the AD mentioned "taking into account its expectations of forgiving lease payments", without limiting these to credit risk related events, blurred the boundary between expected credit loss and contract modification.

Prevalence in Europe

103 The feedback received by the EFRAG Secretariat during the preliminary work highlighted that this issue is prevalent in Europe.

Priority in Europe

104 The EFRAG Secretariat notes that there is diversity in practice regarding the extent to which cash shortfalls should be considered in the calculation of ECL. The EFRAG Secretariat also considers that the AD could have wider implications than lease receivables and cause undue disruption to long-standing general accounting practices for financial assets.

105 Therefore, the EFRAG Secretariat considers that the IASB should clarify whether the expression "all cash shortfalls" should be interpreted within the scope of concessions from the lender due to financial difficulties of the borrower. This topic is considered as high priority by the EFRAG Secretariat.

IASB Category	General approach to impairment
Criterion	Diversity in practice
Prevalence in Europe	Prevalent
Priority in Europe	High

Issue 7 – Revolving credit facilities

106 ECL is to be calculated based on existing exposures at the end of the reporting period. Existing exposures originate from recognised financial instruments and the maximum period to consider when measuring expected credit losses is the maximum contractual period (including extension options) over which the entity is exposed to credit risk and not a longer period, even if that longer period is consistent with business practice. Paragraph 5.5.20 of IFRS 9 provides an exception from this rule in accordance to which "*some financial instruments include both a loan and an undrawn commitment component and the entity's contractual ability to demand repayment and cancel the undrawn commitment does not limit the entity's exposure to credit losses to the contractual notice period*". For such financial instruments, and only for those financial instruments, an entity shall measure expected credit losses 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.

107 Paragraph B5.5.39 (c) of IFRS 9 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 (paragraph B5.5.40 of IFRS 9):

(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.

Issue 7.1: Scope of the exception

108 Products that are generally agreed to be in the scope of the IFRS 9 paragraph 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 paragraph 5.5.20.

109 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.

110 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.

Prevalence in Europe

111 The feedback received during the EFRAG Secretariat preliminary work highlighted that this issue is prevalent in Europe.

Priority in Europe

112 **The EFRAG Secretariat understands that diversity in practice occurs 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**.

113 The EFRAG Secretariat has been informed that more guidance from the Standard is needed in order to 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. The EFRAG Secretariat has identified this as a medium priority issue.

IASB Category	Measurement of ECL
Criterion	Diversity in practice
Prevalence in Europe	Prevalent
Priority in Europe	Medium

Issue 7.2: Interaction with derecognition

114 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.

115 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.

Prevalence in Europe

116 The feedback received during the EFRAG Secretariat preliminary work highlighted that this issue is prevalent in Europe.

Priority in Europe

117 **The EFRAG Secretariat understands that diversity in practice occurs relating to SICR and thus ECL calculation dependent on the application of the modification and derecognition criteria for revolving credit facilities**.

118 The EFRAG Secretariat has been informed that more guidance from the Standard is needed in order to 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. The EFRAG Secretariat has identified this as a medium priority issue.

IASB Category	Measurement of ECL
Criterion	Diversity in practice
Prevalence in Europe	Prevalent
Priority in Europe	Medium

Issue 7.3: Educational video of IASB staff

119 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.

120 **The EFRAG Secretariat understands that diversity in practice occurs because the existence of an educational video bringing additional assessment criteria**

to IFRS 9 not present in the text of IFRS 9 or in IFRS IC interpretations or agenda decisions.

Prevalence in Europe

121 The feedback received during the EFRAG Secretariat preliminary work highlighted that this issue is prevalent in Europe.

Priority in Europe

122 The EFRAG Secretariat has been informed that more guidance from the Standard is needed in order to include guidance and the key messages provided by the educational video in the Standard. The EFRAG Secretariat has identified this as a medium priority issue.

IASB Category	Measurement of ECL
Criterion	Diversity in practice
Prevalence in Europe	Prevalent
Priority in Europe	Medium

Issue 8 – Calculating ECL on intra group loans (loans between entities under common control)

123 IFRS 9 requires entities to recognise expected credit losses for all financial assets held at amortised cost, including most intra group 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.

124 In practice, significant difficulties are observed in how calculating ECL on intra group loans since in most cases for these loans:

(a) there is no experience of losses;

(b) a bank would never grant the credit 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 controlling entity. Therefore, the assessment of the borrower's ability to redeem the loan would not provide the right reflection of the controlling entity's intention and the expected cash flows as seen from the lender.

125 Finally, a number of these loans may not be the result of arm's length transactions and a controlling entity generally avoids losses on intra group loans by providing for capital injections.

Prevalence in Europe

126 It is reported that there is diversity in practice on which PD to use (originator's or underlying position) in calculating the ECL in the separate financial statements of a SPV where the SPV is used by a bank as funding vehicles for loans which were not derecognised from the bank financial statements as all the risks and rewards were substantially retained.

127 **Some advocate for the removal of intra group 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**.

Priority in Europe

128 Intra group loans are a potentially very inhomogeneous group of financial assets. Some of these loans may have characteristics that make ECL calculation difficult, some might have characteristics that make ECL calculation more straight forward and some may have characteristics that make ECL calculation resulting in immaterial figures. The EFRAG Secretariat understands that this issue may to some extent be overlapping with the issue of simplified rules for corporates. Applying the same arguments as for simplified rules for corporates the EFRAG Secretariat considers this a low priority issue.

IASB Category	Measurement of ECL
Criterion	Requirements and application guidance difficult to be applied consistently
Prevalence in Europe	Prevalent
Priority in Europe	Low

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

129 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.

130 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*".

131 Due to a pre-defined waterfall structure, the issuer of a CLI only transfers the 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. Proponents of this argument will note that changes in expected cash flows will lead to changes in gross amortised cost and effects in profit or loss according to the regulations in IFRS 9 paragraph B5.4.6.

132 A different view states that IFRS 9 deems certain tranches of 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 event and an estimation of the amount of any losses that will be incurred must be reflected in the credit loss allowance.

133 The EFRAG Secretariat has been informed that more guidance on if and, if applicable, when a CLI should be considered in default would be appropriate.

Prevalence in Europe

134 The feedback received during the EFRAG Secretariat preliminary work highlighted that this issue is prevalent in Europe.

Priority in Europe

135 The issue is considered to be easily solvable either through clarifying guidance in IFRS 9 or disclosure requirements in IFRS 7. The EFRAG Secretariat has identified this as a medium priority issue.

IASB Category	Measurement of ECL
Criterion	Requirements and application guidance difficult to be applied consistently
Prevalence in Europe	Prevalent
Priority in Europe	Medium

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

136 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).

137 According to paragraph B5.5.33 when a financial 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. 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.

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

139 The EFRAG Secretariat understands that diversity in practice occurs 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. This has an implications on the application of EIR (net vs gross basis).

Prevalence in Europe

140 This is the EFRAG Secretariat understanding that this diversity in practice is not wide-spread among European constituents.

Priority in Europe

141 IFRS 9 already requires applying the EIR on the net basis for the credit-impaired financial assets starting from the next reporting period. The EFRAG Secretariat is unaware of any material impacts from the timing differences in the application of the EIR. Other questions on the application of the EIR will be dealt withing the project *Amortised Cost Measurement* that is currently a part of the IASB research project pipeline. This issue is considered to be a low priority.

IASB Category	Other topics
Criterion	Diversity in practice
Prevalence in Europe	Not prevalent
Priority in Europe	Low

Issue 11 – Write-offs – diversity in practice

142 IFRS 9 requires an entity to directly reduce the gross carrying amount of a financial asset when the entity has no reasonable expectations of recovering a financial asset in its entirety or a portion thereof. **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.

143 The EFRAG Secretariat have received feedback that the requirement "has no reasonable expectation of recovering" in IFRS 9, paragraph 5.4.4 needs further application guidance.

Prevalence in Europe

144 This is the EFRAG Secretariat understanding that this diversity in practice is widespread among European constituents.

Priority in Europe

145 IFRS 7 requires information regarding write-off policy and financial assets that are written-off (paragraph 35F(e) and 35I(c)). The assessment on when there is no reasonable expectation of recovering is inherently subjective. Further guidance may help limit the range of the diversity in assessments. The EFRAG Secretariat considers this issue to be a low priority. The EFRAG Secretariat also notes that this issue could be considered for the clarification on the interaction between modification, impairment, and derecognition (see issues 2).

IASB Category	Other topics
Criterion	Diversity in practice
Prevalence in Europe	Prevalent
Priority in Europe	Low

Issue 12 – Reliability of forward-looking information

146 In the event of major crises/changes, 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**.

147 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.

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

Prevalence in Europe

149 The feedback received during the EFRAG Secretariat preliminary work highlighted that this issue is not prevalent in Europe.

Priority in Europe

150 With the exception of what is highlighted in issues 19.1 and 19.2, regarding disclosures, and on issue 20, regarding the wording "undue cost or effort", the EFRAG Secretariat considers that IFRS 9 provides adequate guidance on how to

incorporate detailed forecasts of future conditions in the estimation of ECLs, based on their availability. Therefore, this topic is considered as low priority by the EFRAG Secretariat.

IASB Category	General approach to impairment
Criterion	Requirements and application guidance difficult to be applied consistently
Prevalence in Europe	Not prevalent
Priority in Europe	Low

Issue 13 – Interaction between derecognition and ECL amount

151 It is noted that the accounting requirements for loan restructurings in case of difficulties of the debtor (i.e., due to COVID-19) 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 (if it is not considered POCI) 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)**.

152 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 from which to deduct the lifetime ECL allowance.

153 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).

Prevalence in Europe

154 The feedback received during the EFRAG Secretariat preliminary work highlighted that this issue has some prevalence in Europe..

Priority in Europe

155 The EFRAG Secretariat considers that IFRS 13 provides sufficient guidance on how the determine the fair value of a financial instrument, even though it may not be directly observable. If the financial asset is not considered credit-impaired at initial recognition, then the 12-months ECL allowance seems appropriate, although it is doubtful that a restructured due to the financial difficulties of a customer loan could be classified at stage 1. For the POCI assets it is assumed that the 12-months ECL is already reflected at the fair value of the financial asset at initial recognition. Based on the above the EFRAG secretariat considers this issue to be a low priority. The EFRAG Secretariat also notes that this issue could be considered for the clarification on the interaction between modification, impairment, and derecognition (see issues 2).

IASB Category	General approach to impairment
Criterion	Diversity in practice
Prevalence in Europe	Some prevalence
Priority in Europe	Low

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

156 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 often to be lacking.

157 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).

Prevalence in Europe

158 The feedback received during the EFRAG Secretariat preliminary work highlighted that this issue has some prevalence in Europe.

Priority in Europe

159 The EFRAG Secretariat considers that there are no fatal flaws on the clarity and suitability of the core objective or principles in the impairment requirements. In addition, the EFFRAG Secretariat is aware of the challenges that the IASB would face in defining what "accidental to the business model" means with a principle-based guidance. Therefore, this topic is considered as low priority by the EFRAG Secretariat.

IASB Category	Credit-impaired on initial recognition
Criterion	Requirements not working as intended
Prevalence in Europe	Some prevalence
Priority in Europe	Low

Issue 15 – Procyclicality of IFRS 9 ECL model

160 Recalling the concept of "procyclicality" considered by IASB when writing the IFRS 9 Standard[1], one concern arising from discussions was 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 to 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 to avoid that an excessively rigorous application of the accounting rules generate pro-cyclical effects and therefore jeopardise the support measures for businesses, launched by the various national governments during the first half of 2020.

161 In addition, the use of a probability of default base on a point-in-time perspective may result in higher volatility in the ECL amounts 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,

[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.

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.

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

Prevalence in Europe

163 The feedback received during the EFRAG Secretariat preliminary work highlighted that this issue is not prevalent in Europe.

Priority in Europe

164 The EFRAG Secretariat considers that there are no fatal flaws on the clarity and suitability of the core objective or principles in the impairment requirements. Therefore, this topic is considered as low priority by the EFRAG Secretariat.

IASB Category	General approach to impairment
Criterion	Requirements not working as intended
Prevalence in Europe	Not prevalent
Priority in Europe	Low

Issue 16 – Portfolios of high credit quality exposures

165 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 in financial statements (instead of the "probability-weighted amounts" IFRS 9 approach). This suggested solution could also prevent the use of significant model adjustments seen 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.

(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 as 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 of application. **A suggestion is made to exempt these exposures from day one ECL provisioning**.

Prevalence in Europe

166 The feedback received during the EFRAG Secretariat preliminary work highlighted that this issue is not prevalent in Europe.

Priority in Europe

167 The EFRAG Secretariat considers that there are no fatal flaws on the clarity and suitability of the core objective or principles in the impairment requirements. The introduction of an exemption for large high quality credit exposures or very well collateralised exposures would involve a number of challenges and questions to

define it with a principle-based guidance. The EFRAG Secretariat considers that this effort would not be outweighed by the benefits for users of financial statements.

168 Therefore, this topic is considered as low priority by the EFRAG Secretariat.

IASB Category	General approach to impairment
Criterion	Requirements not working as intended
Prevalence in Europe	Not prevalent
Priority in Europe	Low

Issue 17 – Credit risk and portfolio performance

169 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.

170 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 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 (Endorsement Advice on IFRS 9 Financial Instruments, paragraph 21(a)).

171 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. 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**.

Prevalence in Europe

172 The feedback received during the EFRAG Secretariat preliminary work highlighted that this issue is not prevalent in Europe.

Priority in Europe

173 The EFRAG Secretariat considers that the considerations made during the endorsement process are still valid and that the feedback received during the preliminary work has not revealed any fatal flaws on the clarity and suitability of the core objective or principles in the impairment requirements.

174 Therefore, this topic is considered as low priority by the EFRAG Secretariat.

IASB Category	General approach to impairment
Criterion	Requirements not working as intended

Prevalence in Europe	Not prevalent
Priority in Europe	Low

Issue 18 – Exposures in stage 1 and stage 2 simultaneously

175 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 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**.

176 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).

Prevalence in Europe

177 The feedback received during the EFRAG Secretariat preliminary work highlighted that this issue is not prevalent in Europe.

Priority in Europe

178 The EFRAG Secretariat considers that the considerations made during the endorsement process are still valid and that the feedback received during the preliminary work has not revealed any fatal flaws on the clarity and suitability of the core objective or principles in the impairment requirements.

179 Therefore, this topic is considered as low priority by the EFRAG Secretariat.

IASB Category	General approach to impairment
Criterion	Requirements not working as intended
Prevalence in Europe	Not prevalent
Priority in Europe	Low

Issue 19 – Understandability and comparability of disclosures

Issue 19.1 – Low comparability of the ECL numbers

180 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].

[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.

181 **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 different stages of the ECL calculation, such as estimation of the significant increase in credit risk, entity specific definition of default, assigning PDs, use of overlays, models applied, etc allows for different degrees of prudence between the entities, resulting in low comparability of the ECL numbers.

182 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**.

Prevalence in Europe

183 The EFRAG Secretariat considers this issue to be prevalent in Europe.

Priority in Europe

184 The quality and comparability of the disclosures are important for the understanding of the ECL numbers by users, therefore the EFRAG Secretariat considers this topic to be a high priority.

IASB Category	Disclosures
Criterion	Diversity in practice
Prevalence in Europe	Prevalent
Priority in Europe	High

Issue 19.2 – Comparability of disclosures

185 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.

186 Although formally compliant with IFRS 7 requirements, **the banks' ECL disclosures are 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, credit risk management policies, methodologies and models applied. The structure of disclosures also varies significantly. 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 jurisdiction**.

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

Prevalence in Europe

188 The feedback received by the EFRAG Secretariat shows that this issue is prevalent in Europe.

Priority in Europe

189 The information provided in the disclosures is important in understanding the credit risk management practices and their impact on the ECL numbers. Users need the information, which is reliable and comparable, therefore this topic is considered as high priority by the EFRAG Secretariat.

IASB Category	Disclosures
Criterion	Diversity in practice

Prevalence in Europe	Prevalent
Priority in Europe	High

Issue 20 – Impact of climate-related risk factors (new)

190 Climate change and environmental degradation are sources of structural change that affect economic activity and, in turn, the financial system. Climate-related and environmental risks are commonly understood to comprise two main risk drivers[3]:

(a) physical risk refers to the financial impact of a changing climate, including more frequent extreme weather events and gradual changes in climate, as well as of environmental degradation, such as air, water and land pollution, water stress, biodiversity loss and deforestation.

(b) transition risk refers to an institution's financial loss that can result, directly or indirectly, from the process of adjustment towards a lower-carbon and more environmentally sustainable economy.

191 Climate-related risks may impact the expected cash flows to be received from a loan and, therefore, the lender's exposure to credit losses. Borrower-specific attributes, physical risks and transition risks, either individually or in combination, may impact expected cash flows as well as the range of potential future economic scenarios considered in measuring ECL and the lender's assessment of significant increases in credit risk.

192 **The EFRAG Secretariat has been informed that more guidance should be provided on how to properly incorporate climate-related risk factors (or ESG factors in general) in the measurement of ECL**, due to wide variety of practices to calculate ECLs.

Prevalence in Europe

193 Climate risk is a rapidly evolving world-wide development and as a result creates a high degree of uncertainty as to how it may impact the worldwide economy. Consequently, the attention of investor and prudential and securities regulators on the effects of climate-related matters on financial statements is rapidly increasing.

Priority in Europe

194 The EFRAG Secretariat notes that IFRS 9 sets out a framework for determining the amount of ECLs, but it does not set bright lines or a mechanistic approach to determining when lifetime losses are required to be recognised. Nor does it dictate the exact basis on which entities should determine forward-looking scenarios to consider when estimating ECLs.

195 Therefore, the EFRAG Secretariat considers it unlikely that the IASB will discuss specific mechanisms of including climate-related risk factors or other ESG factors in the measurement of ECL (this would be in contrast to what the IASB has done with reference to the COVID-19 pandemic).

196 Nevertheless, the EFRAG Secretariat notes that this issue is mainly connected with the definition of which information could be consider "*reasonable and supportable*" and "*available without undue cost or effort*" and the fact that the term undue cost or effort is not defined in the standard. Thus, the EFRAG Secretariat considers that the IASB should develop application guidance in this regard to help entities better interpret this requirement, also adding some specific examples on climate-related risk factors and ESG factors.

197 This topic is considered as medium priority by the EFRAG Secretariat.

[3] EBA, Guide on climate-related and environmental risks, November 2020.

IASB Category	Measurement of ECL
Criterion	Requirements and application guidance difficult to be applied consistently
Prevalence in Europe	Prevalent
Priority in Europe	Medium

EFRAG FIWG and IAWG discussions

EFRAG FIWG meeting on 30 January 2023

198 Members appreciated the work performed by the EFRAG Secretariat in prioritising the issues. As general recommendations, members suggested:

(a) clarifying that a low priority classification would not automatically result in the issue not being reported to the IASB;

(b) highlighting the correlation between some identified issues and the IASB research pipeline project to clarify the requirements in IFRS 9 for modifications of financial assets and liabilities and applying the effective interest method;

(c) explaining the possible clarification needed in the wording of the Standard when additional disclosures are suggested to address the issue.

199 On individual issues, members provided the following comments:

Issue 1.1

200 One member suggested to split the issue in two parts: first relating to the definition of integral and non-integral. This part relates to judgement and it is questionable whether the IASB can improve it. The second part would address how to account for a receivable where the guidance from the IASB will be useful.

Issue 1.2

201 A member suggested to decrease a priority of topic 1.2 as he never seen it in practice. Nevertheless, the member noted that the issue could affect more separate than consolidated financial statements.

Issue 2

202 A member questioned a high priority assigned to this issue as it was already discussed by the IFRS Transition Resource Group for Impairment of Financial Instruments ('ITG') in 2015 and the modification gains and losses on the derecognition of loans in stage 3 should be reported as impairment losses. Therefore, no additional guidance should be necessary.

Issue 3.1

203 A member suggested to increase the priority of the topic together with the issues related to staging and derecognition of a contract. Another member suggested that there will always be a judgement and any changes to established practices will distort the results.

Issue 3.2

204 Members noted that this topic created a lot of debates with the regulators and suggested the IASB to provide a more real-life example on collective assessment of SICR with a top-down approach. Such an example would address the assessment of SICR on collective level, stressing the PD indicators but individual transfer to stage 2.

Issue 3.3

205 One member noted that aligning the default definition for accounting purposes with the regulatory one is controversial, and questions have arisen whether this is the best solution especially when regulatory rules (e.g., 1% threshold) lead to different accounting (e.g., derecognition and subsequent recognition in stage 3).

Issue 4

206 A member noted that when calculating an amortised cost of an instrument IFRS 9 already allows a choice to either apply a spot rate till the end of the life of the instrument or to calculate future cash flows based on forward rate. Therefore, no clarification is needed in this respect.

Issue 6.2

207 Members agreed with the high priority assigned to this issue because the way how one defines the credit risk and default has an important impact on the ECL.

Issue 7

208 Members agreed that additional guidance is needed as the application is not consistent. The existing guidance evolved over-time and created diversity in practice.

Issue 8

209 A member confirmed the pervasiveness of the issue of intra-group loans for the separate financial statements, especially when they are not issued on arm-length conditions and may in fact be perpetual loans.

Issue 11

210 A member questioned the example of 5% not covered by ECL. In this member view it should be accounted for as impairment loss as it relates to cash short falls. The loss element should be 100% according to IFRS 9. The member agreed with a low priority assigned to this issue.

Issue 13

211 A member confirmed difficulties with determining fair value of restructured loans as there were no observable factors apart from a risk-free rate.

212 Another member clarified that restructuring of a loan in stage 2 produces counterintuitive results as it would then be reported in stage 1. The member noted that the restructured loans from stage 3 cannot be reported in stage 1.

Issue 14

213 Members confirmed the difficulties arising in practice with accidental accounting for POCI loans, with particular reference to the calculation of the fair value.

Issue 15

214 Members agreed the IFRS 9 impairment model was designed to be procyclical but questioned whether some more guidance could be useful on the amplitude of this procyclicality (e.g., diversity in practice on how the model reacts to external events). Therefore, members suggested that the issue could be rephrased in this light.

215 Members also noted that the model implies a lot of judgment and complexity which leads to heterogeneity and that in some jurisdictions the regulators tend to push financial institutions to more conservative, homogeneous and contracyclical provisions for ECL. It would be useful to have more guidance in the IFRS 9 to ensure more alignment between the financial institutions.

Issue 16

216 A member pointed out that statistics are not relevant for large high quality credit exposures; individual assessment provides more useful information. He also noted that regulators often push banks to move high quality credit exposures to stage 2 when there is a significant increase in credit risk despite the exemption available in IFRS 9 (paragraph 5.5.10). The member considered that the issue should be mentioned to the IASB as the results of the application of the IFRS 9 ECL model to this type of loans do not provide useful information to users of financial statements.

Issue 19

217 A member noted that diversity in practice mentioned in some of the issues (e.g., prohibition period to transfer a loan back to stage 1) could be addressed through disclosures.

EFRAG IAWG meeting on 1 February 2023

218 Members noted that given that insurance industry was still in the implementation stage of IFRS 9, it was too early for them to provide specific comments on completeness, prevalence and importance of the topics.

219 Nevertheless, members noted the following issues which may have relevance for the insurance industry in the future.

Issue 5

220 Some members noted that the issue illustrated for corporate could also be extended to insurance companies, with particular reference to the small portion of portfolio made up of loans. This implies the implementation of costly and complex systems for calculating not-material ECL amounts.

Issue 15

221 Members shared the EFRAG FIWG's comment that the IFRS 9 impairment model was designed to be procyclical and stated that the issue is prevalent in Europe. One member, with a user background, noted that analysis of financial statements of financial institutions has shown that the IFRS 9 impairment model has produced more volatile results than prudential model and, in some cases, the higher volatility did not give rise to useful information for users of financial statements.

Issue 16

222 Members highlighted that the issue could be prevalent for the insurance industry as in general the insurers' portfolio is mainly composed of large exposures of high quality or government bonds. Members suggested monitoring the potential impact of the issue.