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 – List of issues – Issues Paper

Objective

1 The objective of this paper is to present an updated list of issues that EFRAG will as basis for response to the forthcoming RFI of the PIR of IFRS 9 – *Impairment*.

2 The updated list presented below takes into consideration the feedback provided by EFRAG FR TEG members during their last meeting on 9 February 2023.

3 Appendix 1 provides a reconciliation table between the agenda paper 05-02 for EFRAG FR TEG meeting on 9 February 2023 and the issues described in this agenda paper.

4 Appendix 2 provides the description of the preliminary issues that EFRAG FR TEG has decided not to report to the IASB in response to the forthcoming RFI.

Summary

5 The table below summarises the issues that will be reported to the IASB in response to the forthcoming RFI of the PIR of IFRS 9 – *Impairment* and the EFRAG preliminary assessment on prevalence and priority in Europe.

#	Issue	IASB Category	Criterion	Prevalence in Europe	Priority in Europe
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
1.2	Joint and several guarantees	Loan commitments and financial guarantees	Diversity in practice	Some prevalence	Medium
2	Interaction between ECL and other requirements	Interaction between ECL and other requirements	Requirements and application guidance difficult to be applied consistently	Prevalent	High
3	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	Medium

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
5	Simplified rules for corporates	Simplified approach for trade in lease receivables	Requirements and application guidance difficult to be applied consistently	Not prevalent	Low
6	Determination of credit risk	General approach to impairment Interaction between ECL and other requirements	Diversity in practice	Prevalent	High
7.1	Revolving credit facilities – Scope of the exception	Loan commitments and financial guarantees	Diversity in practice	Prevalent	Medium
7.2	Revolving credit facilities – Interaction with derecognition	Loan commitments and financial guarantees	Diversity in practice	Prevalent	Medium
7.3	Revolving credit facilities – Educational video of IASB Staff	Loan commitments and financial guarantees	Diversity in practice	Prevalent	Medium
8	Calculating ECL on intragroup loans	General approach to impairment	Requirements and application guidance difficult to be applied consistently	Prevalent	Medium
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
10	Timing to move to stage 3 (next reporting date or during the reporting period)	Other topics	Diversity in practice	Not prevalent	Low
11	Purchased or originated credit-impaired financial assets (POCI), alternative treatment of ECL	POCI financial assets	Requirements not working as intended	Some prevalence	Medium
12	Portfolios of high credit quality exposures	General approach to impairment	Requirements not working as intended	Some prevalence	Medium
13	Credit risk and portfolio performance	General approach to impairment	Requirements not working as intended	Not prevalent	Low

14	Exposures in stage 1 and stage 2 simultaneously	General approach to impairment	Requirements not working as intended	Not prevalent	Low
15	Consistency and comparability of disclosures	Disclosures	Diversity in practice	Prevalent	High
16	Impact of climate-related risk factors	Measurement of ECL	Requirements and application guidance difficult to be applied consistently	Prevalent	Medium

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.

Issuer perspective

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 an accounting 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. The most frequent example of these guarantee is within a group, when cross-company guarantee arrangements meet the definition of financial guarantee contracts.

21 In calculating the ECLs on cross-company guarantees relating to loans to a group entity made by parties external to the group, each entity that is part to the cross-company guarantee arrangement needs to factor in the likelihood of it being called upon to make payments under the arrangement. Furthermore, entities should consider the reimbursements they expect to receive from each other.

22 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

23 The feedback received during the EFRAG Secretariat preliminary work highlighted that this issue has some prevalence in Europe. The issue is more prevalent in jurisdictions where separate financial statements are prepared in accordance with IFRS Accounting Standards.

Priority in Europe

24 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 – Interaction between ECL and other requirements

25 Several issues are identified in this area:

(a) Presentation of modification gains / losses vs impairment;

(b) Write-offs – diversity in practice; and

(c) Interaction between derecognition and ECL amount.

<u>Presentation of modification gains / losses vs impairment</u>

26 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.

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

28 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.

29 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*".

30 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.

31 **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?**

32 **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?**

Write-offs – diversity in practice

33 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.

34 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.

Interaction between derecognition and ECL amount

35 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)**.

36 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.

37 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

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

Priority in Europe

39 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).

40 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.

41 Furthermore, in July 2022, considering the feedback received during the PIR of IFRS 9 – *Classification and Measurement*, the IASB decided to add a standard-setting project to its research pipeline to clarify the requirements in IFRS 9 for modifications of financial assets and liabilities and applying the effective interest method. Several application questions with potential effects in ECL amounts have been identified by the IASB Staff in this area, reinforcing the need of clarification.

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

IASB Category	Interaction between ECL and other requirements
Criterion	Requirements and application guidance difficult to be applied consistently
Prevalence in Europe	Prevalent
Priority in Europe	High

Issue 3 – Collective assessment of SICR: bottom-up vs top-down approach

43 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.*"

44 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.

45 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.

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

Prevalence in Europe

47 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

48 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.

49 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.

50 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.

51 Instead, the EFRAG Secretariat would suggest the IASB to provide a more real-life examples on collective assessment of SICR with a top-down approach. Such examples would address the assessment of SICR on collective level, stressing the PD indicators but individual transfer to stage 2, and whether and how the two approaches can be applied simultaneously.

52 This topic is considered as medium 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	Medium

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

53 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).

54 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.

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

Relevant IFRS requirements

56 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). 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).

57 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).

58 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).

59 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.

60 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. 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

61 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

62 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

63 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. This project will also cover the request received by the IFRS Interpretation Committee to clarify how to apply the effective interest method in cases where there is conditionality attached to the contractual interest rate, in the context of the agenda decision *TLTRO III Transactions (IFRS 9 and IAS 20)*.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

64 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.

65 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.

66 **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

67 This is the EFRAG Secretariat understanding that this issue has low prevalence in Europe. However, the EFRAG Secretariat acknowledges that the issue may increase in prevalence following the implementation of the IFRS 9 by the insurance industry.

Priority in Europe

68 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 – Determination of credit risk

69 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.

70 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.

71 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.

72 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'.*

73 *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.*"

74 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)**.

75 Furthermore, 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).

76 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.

77 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

78 The feedback received by the EFRAG Secretariat during the preliminary work highlighted that this issue is prevalent in Europe. In particular, as consequence of the COVID-19 pandemic, several jurisdictions have introduced different types of bank holidays which have increased the application questions related to the definition of "credit losses" and related to the boundary between modification and credit risk.

Priority in Europe

79 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.

80 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. In addition, the EFRAG Secretariat notes that this issue is closely connected with issue 2 – *Interaction between ECL and other requirements*.

81 This topic is considered as high priority by the EFRAG Secretariat.

IASB Category	General approach to impairment Interaction between ECL and other requirements
Criterion	Diversity in practice
Prevalence in Europe	Prevalent

Priority in Europe	High

Issue 7 – Revolving credit facilities

82 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.

83 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

84 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.

85 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.

86 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

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

Priority in Europe

88 **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.

89 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	Loan commitments and financial guarantees
Criterion	Diversity in practice
Prevalence in Europe	Prevalent
Priority in Europe	Medium

Issue 7.2: Interaction with derecognition

90 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.

91 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

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

Priority in Europe

93 **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**.

94 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	Loan commitments and financial guarantees
Criterion	Diversity in practice
Prevalence in Europe	Prevalent
Priority in Europe	Medium

Issue 7.3: Educational video of IASB Staff

95 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.

96 **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

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

Priority in Europe

98 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	Loan commitments and financial guarantees
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)

99 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.

100 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.

101 Furthermore, 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. These challenges are even more evident in relationships in which the lender has control over the borrower. In this circumstance, the parent has the ability to control the cash flows and the payment / repayment terms and has the ability to convert the loans into equity. Therefore, when the lender has such ability, the loans assume a risk profile similar to the one of an equity instrument, taking the nature of a capital contribution.

102 Additionally, in case of liquidation, in some jurisdictions in Europe, shareholders' financing in favour of the entity are subordinated to the satisfaction of the other creditors, therefore those loans become equivalent to an equity instrument.

103 As a further case, 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.

104 **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**.

Prevalence in Europe

105 The feedback received during the EFRAG Secretariat preliminary work highlighted that this issues is prevalent in Europe and it is more prevalent in jurisdictions where separate financial statements are prepared in accordance with IFRS Accounting Standards.

Priority in Europe

106 The EFRAG Secretariat notes that calculation ECL on intra group loans may imply a significant effort and result in immaterial figures. In many cases, intra group loans may be "on demand", "perpetual" or "off-market" and the parent company may be willing to convert the loan into a capital contribution, if necessary.

107 Furthermore, the EFRAG Secretariat notes that the FASB excluded loans and receivables between entities under common control from the scope of its expected losses impairment model (ACS 326, paragraph 326-20-15-3).

108 Therefore, the EFRAG Secretariat identified this issue as a medium priority and considers that the IASB should consider introducing simplified rules for intra group loans.

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

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

109 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. 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*".

110 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.

111 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.

112 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

113 The feedback received during the EFRAG Secretariat preliminary work highlighted that this issue is prevalent in Europe, considering the incremental number of standardised securitisations with senior tranches with SPPI cash flows.

Priority in Europe

114 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)

115 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).

116 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.

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

118 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

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

Priority in Europe

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

121 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.

122 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

123 The feedback received during the EFRAG Secretariat preliminary work highlighted that this issue has some prevalence in Europe, although it has been noted that the market for NPLs acquisition and portfolio management is on the rise.

Priority in Europe

124 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.

125 Nonetheless, the EFRAG Secretariat acknowledges some application matters which highlight the need for more clarity on the POCI's requirements. In particular, it would be useful to have more guidance on:

(a) the extent to which a POCI financial asset could be allocated both upon initial recognition and in subsequent periods (stage 2 and 3 or stage 3 only);

(b) the presentation of movements in expected credit losses on POCI financial assets, especially in the case where there is an improvement in credit quality in excess of the entity's expectations at initial recognition.

(c) how the modification requirements interact with the POCI requirements

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

IASB Category	POCI financial assets
Criterion	Requirements not working as intended
Prevalence in Europe	Some prevalence
Priority in Europe	Medium

Issue 12 – Portfolios of high credit quality exposures

127 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

128 The feedback received during the EFRAG Secretariat preliminary work highlighted that this issue is not prevalent in Europe. However, the EFRAG Secretariat acknowledges that the issue will increase in prevalence following the implementation of the IFRS 9 by the insurance industry.

Priority in Europe

129 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.

130 Nonetheless, the EFRAG Secretariat notes that statistics may be not relevant for large high quality credit exposures and that individual assessment could provide more useful information. Therefore, the EFRAG Secretariat considers that the IASB

should consider this issue as the application of the IFRS 9 ECL model to this type of financial assets could provide results that users of financial statements may not consider useful.

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

IASB Category	General approach to impairment
Criterion	Requirements not working as intended
Prevalence in Europe	Some prevalence
Priority in Europe	Medium

Issue 13 – Credit risk and portfolio performance

132 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.

133 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)).

134 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

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

Priority in Europe

136 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.

137 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 14 – Exposures in stage 1 and stage 2 simultaneously

138 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**.

139 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

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

Priority in Europe

141 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.

142 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 15 – Consistency and comparability of disclosures

143 The forward-looking approach in the expected credit losses model requires the application of judgement. The judgements and estimates are 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[1].

[1] 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
(b) entities can perform the assessment at counterparty rather than at individual instrument level. 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.

144 **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.

145 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**.

146 Furthermore, 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.

147 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**.

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

Prevalence in Europe

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

Priority in Europe

150 The information provided in the disclosures is important in understanding the credit risk management practices and their impact on the ECL numbers. Users need high quality information, which is reliable and comparable.

151 Areas that could be considered to increase consistency and comparability of disclosures are, for example:

(a) how the ECL model parameters (e.g., PD, LDG, and EAD) were defined and their interaction with the definition of default ;

(b) criteria applied in determining significant increase in credit risk in presence of modifications or forbearance measures;

(c) probability-weighted outcome and approaches to incorporate multiple economic scenarios;

(d) sensitivity analysis, back-testing and reconciliation forms; and

(e) post model adjustments.

152 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 16 – Impact of climate-related risk factors

153 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[2]:

(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.

154 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.

155 **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

156 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

157 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.

158 Nonetheless, the EFRAG Secretariat notes that the significant relevance and the extensive impacts of ESG factors in measuring ECL should be considered by the IASB in the context of the PIR of IFRS 9 – *Impairment* or under the *Climate-related Risks in the Financial Statements* pipeline project.

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

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

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

Appendix 1: Reconciliation table

1 The table below provides a reconciliation between the agenda paper 05-02 for EFRAG FR TEG meeting on 9 February 2023 and the issues described in this agenda paper (changes are indicated in red).

#	Issue	IASB Category	Criterion	Prevalence in Europe	Priority in Europe	Notes
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	
1.2	Joint and several guarantees	Loan commitments and financial guarantees	Diversity in practice	Some prevalence	Medium	The description has been updated
2	Interaction between ECL and other requirements ~~Presentation of modification gains / losses vs impairment~~	Interaction between ECL and other requirements ~~Other topics~~	Requirements and application guidance difficult to be applied consistently	Prevalent	High	This issue groups issues 2, 11, and 13.
~~3.1~~	~~Stage allocation: modification in presence of forbearance~~	~~Determining significant increases in credit risk~~	~~Diversity in practice~~	~~Prevalent~~	~~Low~~	The issue has been removed
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	Medium ~~Low~~	The description has been updated
~~3.3~~	~~Definition of default and "prudence" layer~~	~~General approach to impairment~~	~~Requirements and application guidance difficult to be applied consistently~~	~~Prevalent~~	~~Low~~	The issue has been removed
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	
5	Simplified rules for corporates	Simplified approach for trade in lease receivables	Requirements and application guidance difficult to be applied consistently	Not prevalent	Low	
~~6.1~~	~~Application of ECL to lease receivables~~	~~General approach to impairment~~	~~Diversity in practice~~	~~Prevalent~~	~~Medium~~	Issues 6.1 (a), 6.1 (b), and 6.1 (c) have been removed Issue 6.1 (d) has been combined

						with issue 6.2 (now issue 6)
6~~.2~~	Determination of credit risk	General approach to impairment ~~Interaction between ECL and other requirements~~	Diversity in practice	Prevalent	High	
7.1	Revolving credit facilities – Scope of the exception	Loan commitments and financial guarantees ~~Measurement of ECL~~	Diversity in practice	Prevalent	Medium	
7.2	Revolving credit facilities – Interaction with derecognition	Loan commitments and financial guarantees ~~Measurement of ECL~~	Diversity in practice	Prevalent	Medium	
7.3	Revolving credit facilities – Educational video of IASB Staff	Loan commitments and financial guarantees ~~Measurement of ECL~~	Diversity in practice	Prevalent	Medium	
8	Calculating ECL on intragroup loans	General approach to impairment ~~Measurement of ECL~~	Requirements and application guidance difficult to be applied consistently	Prevalent	Medium ~~Low~~	The description has been updated
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	
10	Timing to move to stage 3 (next reporting date or during the reporting period)	Other topics	Diversity in practice	Not prevalent	Low	
~~11~~	~~Write-offs – diversity in practice~~	~~Other topics~~	~~Diversity in practice~~	~~Prevalent~~	~~Low~~	This issue has been grouped in issue 2
~~12~~	~~Reliability of forward-looking information~~	~~General approach to impairment~~	~~Requirements and application guidance difficult to be applied consistently~~	~~Not prevalent~~	~~Low~~	The issue has been removed

~~13~~	~~Interaction between derecognition and ECL amounts~~	~~General approach to impairment~~	~~Diversity in practice~~	~~Some prevalence~~	~~Low~~	This issue has been grouped in issue 2
11 ~~14~~	Purchased or originated credit-impaired financial assets (POCI), alternative treatment of ECL	POCI financial assets ~~Credit-impaired assets on initial recognition~~	Requirements not working as intended	Some prevalence	Medium ~~Low~~	The description has been updated
~~15~~	~~Procyclicality of IFRS 9 ECL model~~	~~General approach to impairment~~	~~Requirements not working as intended~~	~~Not prevalent~~	~~Low~~	The issue has been removed
12 ~~16~~	Portfolios of high credit quality exposures	General approach to impairment	Requirements not working as intended	Some prevalence ~~Not prevalent~~	Medium ~~Low~~	The description has been updated
13 ~~17~~	Credit risk and portfolio performance	General approach to impairment	Requirements not working as intended	Not prevalent	Low	
14 ~~18~~	Exposures in stage 1 and stage 2 simultaneously	General approach to impairment	Requirements not working as intended	Not prevalent	Low	
15 ~~19.1~~	Consistency and comparability of disclosures ~~Low comparability of the ECL numbers~~	Disclosures	Diversity in practice	Prevalent	High	The description has been updated
~~19.2~~	~~Comparability of disclosures~~	~~Disclosures~~	~~Diversity in practice~~	~~Prevalent~~	~~High~~	This issue has been grouped in issue 19.1 (now issue 15)
16 ~~20~~	Impact of climate-related risk factors (new)	Measurement of ECL	Requirements and application guidance difficult to be applied consistently	Prevalent	Medium	The description has been updated

Appendix 2: Issues that EFRAG FR TEG has decided not to report to the IASB in response to the forthcoming RFI

Issue 3.1 – Stage allocation: modification in presence of forbearance

2 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

3 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

4 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).

5 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.

6 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.

7 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

8 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.

9 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.

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

Issue 3.3 – Definition of default and "prudence" layer

11 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**.

12 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.

13 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.

Issue 6.1 – Application of ECL to lease receivables

14 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

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

15 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

16 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.

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

Recognition of lease income when collectability is not probable

18 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.

Issue 12 – Reliability of forward-looking information

19 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**.

20 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.

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

Issue 15 – Procyclicality of IFRS 9 ECL model

22 Recalling the concept of “procyclicality” considered by IASB when writing the IFRS 9 Standard[3], 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.

23 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, 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.

24 **In the short term, the concern has changed from “too little, too late” to “too much, too soon”**.

[3] 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.