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PIR IFRS 9 Impairment

Significant increases in credit risk – feedback analysis

Objective

- 1 The objective of this session is to seek EFRAG FR TEG views on the IASB staff feedback analysis and recommendations and the IASB tentative decisions on the significant increases in credit risk ('SICR').

Summary of the feedback received

- 2 Almost all respondents supported the principles-based approach to assessing whether SICR occurred and said that there are no fundamental questions (fatal flaws) with the requirements. They said that the approach generally works as intended, including in times of uncertainty such as COVID-19 pandemic.
- 3 **Many preparers** who commented on this topic said that the principles allow them to **align the SICR approaches to credit risk stewardship**, reflecting expectations about economic losses, which ultimately **result in useful information**. Similarly, entities are able to **tailor the approaches** based on the **characteristics of instruments**, industries they operate in and the **level of sophistication of entity's credit risk management practices**. In their view, **applying judgement is necessary** and varying practices are also inherent in the alignment between accounting and credit risk management practices. Otherwise, the benefits of any comparability achieved would be limited.
- 4 In contrast, **many respondents** (prudential and securities regulators, some standard-setters and accounting firms) said that despite the principles and related guidance in IFRS 9, **requirements are not applied consistently**, and the **varying practices are not always justified by differences in how entities manage credit risk**. As a consequence, seemingly similar financial instruments allocated to different ECL stages and different loss amounts being recognised by different entities for those instruments.
- 5 **Some of these respondents** said the IASB should consider **providing further application guidance or illustrative examples**. **Others shared the view that maintaining principles-based requirements** and enabling entities to align the SICR assessment to their own credit risk management practices **will inevitably lead to diversity in practice**. Instead, they expressed a preference for **improving the disclosures** about the approaches entities use and judgements they make in determining what constitutes a SICR.
- 6 However, **most respondents** asked the IASB to **carefully consider the incremental benefits of any potential standard-setting** in this area. In their view, determining SICR is a key

concept of the ECL model and entities have developed accounting policies, **so amendments could lead to disruption in practice**. They also cautioned against introducing prescriptive rules that might create ‘bright lines’ in attempts to improve comparability.

IASB staff analysis

- 7 IASB staff notes that feedback received suggests that almost all RFI respondents view the principles-based assessment of SICR to be the right approach, although the feedback highlights varying practices used to assess changes in credit risk and the resulting effect on recognition of lifetime ECL. Most of the suggestions from the respondents have already been deliberated the development of IFRS 9 (e.g. an approach based on absolute level of credit risk).
- 8 IASB staff agrees with the respondents who note that principles-based requirements, i.e. clear but broadly defined objectives, and alignment to credit risk management practices inevitably lead to different approaches to assessing SICR. However, in their view, **the fact that entities use varying approaches** in making their assessments **does not automatically indicate the requirements are applied inconsistently**.
- 9 IASB staff also agrees with PIR feedback suggesting that **uniformity does not necessarily result in more useful information**. In their view, electing a single measure to determine SICR might facilitate comparability, but it could not properly reflect the assessment of credit risk across entities, products, and geographical regions.
- 10 However, IASB staff acknowledges feedback indicating that the varying practices to determine SICR are not always justified by differences in entities’ credit risk management.
- 11 Also, IASB staff concluded that **any additional application guidance or illustrative examples** by the IASB could only **result in little incremental benefits**. The application of judgement would continue to be required and questions will arise in other circumstances.
- 12 In addition, IASB staff noted that amendments to IFRS 9 application guidance and illustrative examples would have to go through the same due process as amendments to the Standard and also referred to potential disruptions in the current practice.
- 13 However, the IASB staff decided to consider feedback on potential enhancements to disclosure requirements on determining SICR at a future IASB meeting, along with feedback for other disclosures.

Varying practices in determining SICR

Summary of the feedback received by the IASB

- 14 Prudential and securities regulators provided examples of the varying practices on SICR assessment which might delay the recognition of lifetime ECL:
 - (a) *Setting arbitrarily high thresholds for the risk of default occurring, e.g. above the levels used to inform risk management;*
 - (b) *relaxing/changing the thresholds used to assess SICR for portfolios on which credit quality is likely to deteriorate;*
 - (c) *using a combination of absolute and relative levels of credit risk as thresholds to assess SICR, so that recognition of lifetime ECL is delayed until both sets of thresholds are met.*

- 15 Many respondents made general suggestions for additional application guidance or illustrative examples to support a more consistent assessment of 'significance' in the context of determining SICR, e.g. in the following areas:
- (a) *objective of determining SICR*. A respondent noted that the IASB should articulate more clearly the objective of the SICR assessment, which might assist entities in developing qualitative SICR approaches.
 - (b) *absolute level of credit risk* - a few respondents suggested the IASB reconsiders whether an approach based on absolute changes in credit risk, in combination with the current relative approach, could result in better comparability. They also asked whether the term 'maximum credit risk' (paragraph BC5.161 of the Basis for Conclusions on IFRS 9) implies the use of the absolute level of credit risk.
 - (c) *counterparty assessment of SICR* - a few respondents were concerned that different ECL amounts (e.g. 12-month ECL for one instrument and lifetime ECL for others) are recognised for financial instruments held with the same counterparty, because IFRS 9 requires that the SICR assessment is performed at the financial instrument level, and not at the counterparty, level.
 - (d) *low credit risk exemption* - a few preparers said that regulators or auditors generally discourage the use of the 'low credit risk' exemption in paragraph 5.5.10 of IFRS 9 and suggested the IASB clarifies the scope of the exemption, so that it can be applied to different types of financial instruments.
- 16 Respondents shared **mixed views on the fact that IFRS 9 does not define default**:
- (a) a few respondents suggested adding more specific application guidance about the notion of default.
 - (b) many others supported the lack of definition because it allows for alignment with thresholds used for credit risk management and regulatory purposes. They noted that, most regulated entities in a jurisdiction tend to apply a definition consistent with what is used for regulatory purposes and that any diversity arising (e.g. from entities that are not regulated) is mitigated by the 90-day rebuttable presumption in IFRS 9 which serves as a 'backstop'.

EFRAG comment letter

- 17 EFRAG is of the view that the principle-based approach instead of prescriptive rules to assessing SICR helps to achieve the IASB's objective of recognising lifetime ECL when there has been a SICR since initial recognition.
- 18 EFRAG is of the view that, generally, the assessment of SICR can be applied consistently.

IASB staff analysis and recommendations

- 19 The IASB staff considered feedback concerning the varying practices which delay the recognition of lifetime ECL and noted that omitting reasonable and supportable information available that is indicative of SICR, is not consistent with IFRS 9 (see paragraph 5.5.9 of IFRS 9). Similarly, using approaches based only on the absolute credit risk at each reporting date would be inconsistent with IFRS 9.

Objective of determining SICR

- 20 IASB staff noted that the **objective of impairment requirements** in IFRS 9 is to recognise **lifetime ECL for all financial instruments for which there have been SICR since initial recognition**, considering all reasonable and supportable information, including that which is forward-looking. The **objective of determining SICR** is therefore **to capture all the financial instruments that, at the reporting date, have SICR since initial recognition**. Furthermore, IFRS 9 emphasises the importance of identifying such increases in a timely manner **before financial instruments become past due**.

Absolute level of credit risk

- 21 The IASB staff referred to paragraph BC5.160 of the Basis for Conclusions on IFRS 9 which explains that using only an absolute level of credit risk to identify financial assets for which lifetime ECL are recognised was considered, but rejected, by the IASB. The IASB concluded that, while that approach might be simpler to apply because it would not require tracking of changes in credit risk since initial recognition, **it would not capture the economic effect of initial credit loss expectations and subsequent changes in those expectations**. Also, depending on which absolute credit risk threshold is selected, such an approach **might result in understatement or overstatement of ECL, or be similar to the incurred loss model in IAS 39**. In the IASB staff view, the PIR feedback does not provide any evidence on how these disadvantages which informed the IASB's conclusion at the time would be resolved now.
- 22 The IASB staff also believes that the term '**maximum initial credit risk**' as used in paragraph BC5.161 of the Basis for Conclusions on IFRS 9, seeks to explain that an entity could nonetheless use an absolute threshold to capture changes in credit risk relative to initial recognition. (However, in their view, this term would not justify the use of only an absolute level of credit risk that does not take into account the credit risk of the financial instrument at initial recognition.)

Counterparty assessment

- 23 The IASB staff notes that assessing changes in credit risk on a counterparty basis (i.e. all financial instruments held with the same borrower) was also considered, but rejected, by the IASB. The rationale is described in paragraph BC5.167 of the Basis for Conclusions on IFRS 9.
- 24 However, IASB staff acknowledges, with reference to paragraph BC5.168 of the Basis for Conclusions on IFRS 9, that **assessing credit risk on a basis** that considers a **customer's credit risk** (i.e. the risk that a customer will default on its obligations) **more holistically may nevertheless be consistent with the impairment requirements**.

Low credit risk exemption

- 25 The IASB staff notes that IFRS 9 does not list the types of financial instruments that are eligible for the exemption but describes the characteristics of the financial instruments for which the low credit risk exemption was designed. They include the financial instrument having a low risk of default and the borrower having a strong capacity to meet its contractual cash flow obligations in the near term and adverse changes in economic and business conditions in the longer term.

- 26 Also, the IASB staff notes that an external rating of ‘**investment grade**’ is an example of a financial instrument that may be considered as **having low credit risk**. However, financial instruments are not required to be externally rated to be considered to have low credit risk.
- 27 The IASB staff further notes that the **exemption is inherently not intended to be applied too broadly**. The IASB staff refers to paragraph B5.5.22 of IFRS 9 which clarifies that financial instruments are not considered to have low credit risk when they are regarded as having a low risk of loss simply because of the value of collateral and the financial instrument without that collateral would not be considered low credit risk. Financial instruments are also not considered to have low credit risk simply because they have a lower risk of default than the entity’s other financial instruments or relative to the credit risk of the jurisdiction within which an entity operates.

Definition of default

- 28 At the time of developing IFRS 9 the IASB considered that the notion of default is fundamental to the application of the model and that the point of default would be different for different instruments and across jurisdictions and legal systems. The IASB was convinced by stakeholders’ views that any attempt to be more prescriptive or provide more guidance would add confusion and could result in differing default definitions for credit risk management, regulatory and accounting purposes.
- 29 The IASB staff observes that, in addition to the 90-day backstop, paragraph B5.5.37 of IFRS 9 requires an entity to:
- (a) apply a definition of default that is consistent with the definition used for internal credit risk management purposes for the relevant financial instrument, consistently from one period to another; and
 - (b) consider qualitative indicators of default (for example, for financial instruments that include covenants that can lead to events of default) when appropriate.

Assessing SICR on collective basis

Summary of the feedback received by the IASB

- 30 Some respondents (mostly prudential regulators and some standard-setters) said that despite the IFRS 9 requirements for assessing SICR on a collective basis, there is limited, or inconsistent, use of such an assessment in practice. In their view, the main reasons for this outcome are lack of:
- (a) *clarity over the requirements* - some respondents noted it is **not clear whether IFRS 9 requires collective assessment of SICR, or it is optional**. Specifically, they mentioned that it is not clear in which circumstances a collective assessment is necessary, attributing this to the ambiguity of the wording in paragraph B5.5.1 of IFRS 9;
 - (b) *explicit guidance on the approaches to use for collective assessment* - some respondents suggested the IASB provide more explicit guidance on approaches for collective assessment of SICR. For example, two prudential regulators reported that some entities do not apply the ‘top-down’ approach illustrated in Example 5 of the Illustrative Examples accompanying IFRS 9. A few preparers suggested that the IASB

either expand that example by illustrating more clearly how to determine the share of the portfolio that has SICR or replace it with a more practical illustrative example.

EFRAG comment letter

- 31 EFRAG raised this issue in paragraphs 60 to 63 of its [comment letter](#).
- 32 In particular, EFRAG has been informed that it may not be possible, in practice, to apply the collective assessment (as per paragraph B5.5.1 of IFRS 9) in the way described in the Illustrative Example 5 in IFRS 9.
- 33 Also, EFRAG suggested the IASB provides more real-life examples to increase the application of the collective assessment of SICR and also how to allocate the credit risk to an individual level as required for regulatory purposes. Such examples would ease the difficulties in making the assessment of SICR on a collective level, stressing the probability of default indicators, and whether and how the collective versus individual assessment can be applied simultaneously.

IASB staff analysis and recommendations

- 34 In the IASB staff's view, it is clear that **assessing SICR on a collective basis is not an accounting option, but it is neither a must in all circumstances** (e.g., not when the entity has already met the objective of impairment requirements by evaluating financial instruments individually).
- 35 The IASB staff notes that paragraphs B5.5.1 - B5.5.6 of IFRS 9 and paragraphs BC5.138-BC5.142 of the Basis for Conclusions on **IFRS 9, provide relevant considerations for determining when a collective assessment** may be necessary, including:
- (a) the timeliness of capturing SICR primarily depends on whether the entity has reasonable and supportable information that is available without undue cost or effort to identify such increases in a timely manner before financial assets become past due. There may be a delay between identifying SICR and when the increase in credit risk has actually occurred, meaning an assessment that also evaluates financial instruments collectively is needed;
 - (b) the extent to which existing credit risk management systems capture a comprehensive range of credit risk information that is forward-looking and is updated on a timely basis at the individual instrument level to avoid a delay in identifying financial instruments that have SICR. For example, the delay is more apparent for portfolios of financial instruments that are managed based on past due information only;
 - (c) an entity could use the change in a macroeconomic indicator to determine that the credit risk of one or more segments of financial instruments in the portfolio has increased significantly, although it is not yet possible to identify the individual financial instruments for which credit risk has increased significantly.
- 36 In the IASB staff's view, **expanding current illustrative examples or replacing an example with others is unlikely to result in increased use of collective assessment of SICR**. As the feedback indicates, it is the complex nature of financial instruments that makes it challenging to collectively group them by shared credit risk characteristics. Additional examples or guidance can be useful if they apply to a common arrangement type. However,

providing examples for specific complex fact patterns would be unlikely to help many entities as the outcome could be dependent on small changes to facts and circumstances.

- 37 The IASB staff also noted a respondent’s comment that some entities recognise post-model adjustments aiming to reflect information that has not otherwise been captured through collective assessment of SICR and explained that the IASB will holistically consider all feedback received about post-model adjustments at a future meeting.

The IASB discussions and tentative decision

- 38 Based on the above analysis, the IASB staff recommend the IASB **does not take any further action on matters identified with regards to the requirements in IFRS 9 for determining SICR.**
- 39 Most IASB members agreed that adding application guidance or illustrative examples would have little inherent benefit and may disrupt the existing practice. Some members emphasised that some of the issues mentioned by the respondents may be better addressed by improving relevant disclosures and proposed to address this issue later in the project.
- 40 One IASB member noted, however, that whilst SICR assessment in IFRS 9 is principles-based and judgemental in nature, introducing some bright lines for these judgements may be helpful.
- 41 Following the IASB staff recommendation, the IASB tentatively decided **to take no standard-setting action on matters related to the requirements for determining SICR.** 13 of 14 IASB members agreed with this decision.

EFRAG Secretariat assessment

- 42 The EFRAG Secretariat notes that overall feedback received did not indicate any fatal flaws about the requirements for assessment of SICR which is in line with the EFRAG response in its comment letter.
- 43 The EFRAG Secretariat notes the IASB staff arguments that adding application guidance or illustrative examples may result in limited benefits while it might potentially result in disruption of the existing practice, but considers that they alone are hardly sufficient to justify not taking any action. The EFRAG Secretariat suggests that it might be useful that at the end of the project and based on analysis of different topics, the IASB reconsider whether as a whole the additional illustrative examples or educational material will be warranted.
- 44 For example, with regards to the collective assessment of SICR, the EFRAG Secretariat remains of the view that providing more real-life examples could be helpful to deal with existing application issues similar to those mentioned in paragraphs 60 to 63 of the EFRAG’s comment letter.
- 45 The EFRAG Secretariat questions whether requiring additional disclosure about SICR would address the issues reported.

Questions to EFRAG FR TEG

46 Does EFRAG FR TEG agree with the IASB staff analysis and the IASB tentative decision not to take standard-setting action on matters related to the requirements for assessment of SICR?

47 Does EFRAG FR TEG agree with the EFRAG Secretariat analysis?

Appendix A - IASB staff assessment—Is further action needed?

PIR evaluation requirements	Staff assessment
<p>Are there fundamental questions (i.e. ‘fatal flaws’) about the clarity and suitability of the core objectives or principles in the new requirements?</p>	<p>No. PIR feedback and the staff analysis in this paper on the matters identified indicated that there are no fundamental questions about the clarity and suitability of the core objectives or principles about the requirements for determining SICR.</p>
<p>Are the benefits to users of financial statements of the information arising from applying the new requirements significantly lower than expected?</p>	<p>No. Although some respondents raised concerns on inconsistent application of requirements related to SICR, majority of respondents agree that varying practices in how entities assess changes in credit risk is inherent in the principle-based requirements, which in turn, facilitate alignment to credit risk management practices. That alignment ultimately results in useful information because it supports depiction of expectations about economic losses. However, at a future meeting, the IASB will consider the feedback on the disclosure requirements, including assessing whether any potential amendments might be needed to support consistent disclosures about SICR assessment.</p>
<p>Are the costs of applying some or all of the new requirements and auditing and enforcing their application significantly greater than expected?</p>	<p>No. Although some respondents ask for more explicit application guidance or illustrative examples that would reduce the need to apply judgement, thus, might reduce auditing or enforcement costs in some cases, the PIR feedback did not provide evidence that suggests those costs are significantly greater than what the IASB expected when developing the requirements. We also note that most respondents asked the IASB to carefully consider the incremental benefits of any potential standard-setting in this area, noting potential for significant disruption and operational costs that could arise from a change.</p>