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Staff paper

Agenda reference: 3

Capital Markets Advisory Committee meeting

Date	**March 2024**
Project	**Post-implementation Review (PIR) of IFRS 9—Impairment**
Topic	**Feedback analysis–Credit risk disclosures**
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Purpose of this session

- To share with CMAC members the feedback on application of the credit risk disclosure requirements in IFRS 7, in response to the Request for Information Post-implementation Review of IFRS 9—Impairment (the RFI)
- To seek input from CMAC members on:
  - disclosure requirements that may need enhancements—see questions in slide 4; and
  - potential areas for reduced disclosure requirements—see questions in slide 5

Information for participants

- Slides 6 – 8 provide background on the project
- Slides 9 – 25 provide supporting information to consider in answering the focus questions

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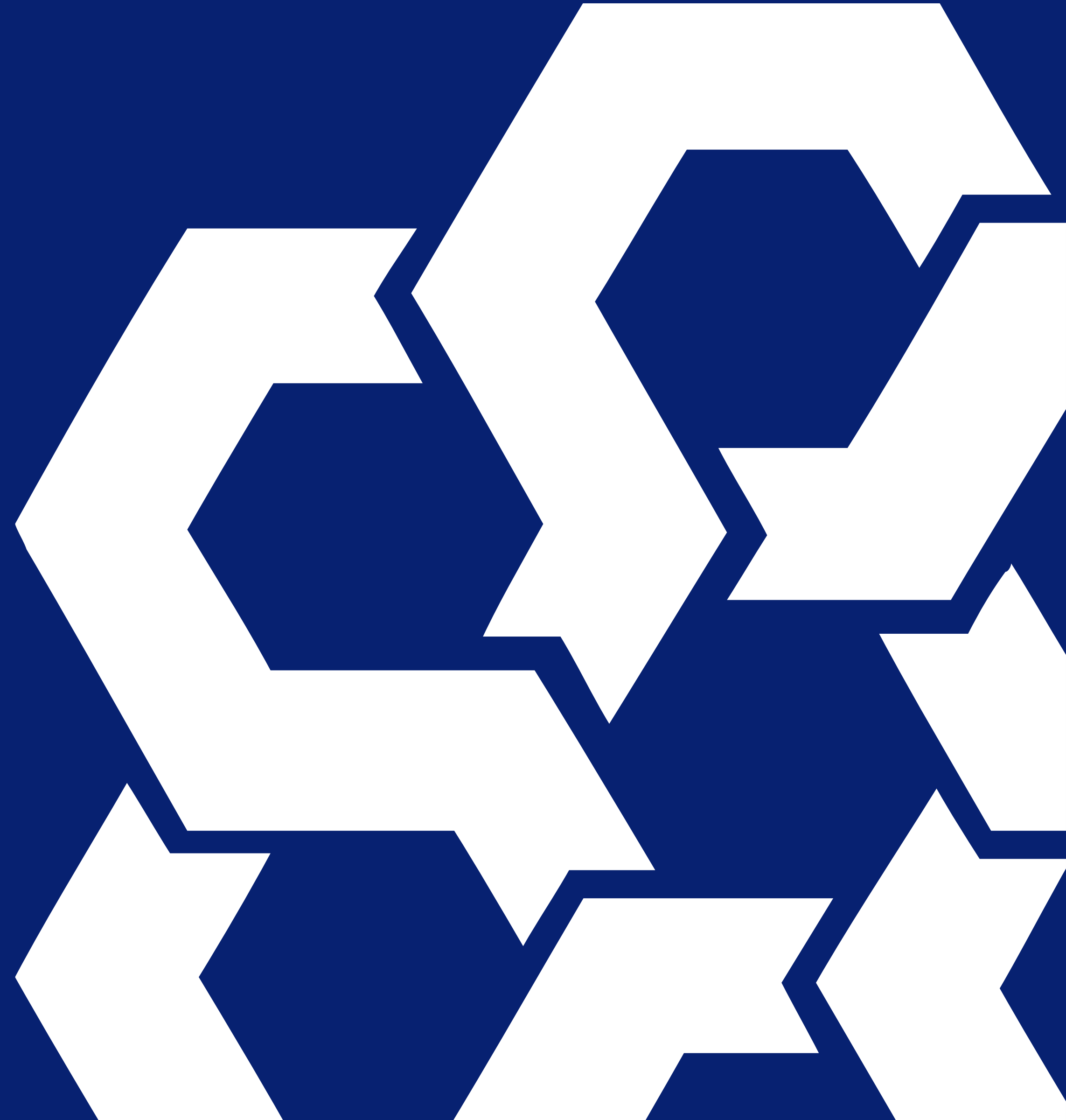
1 Questions for CMAC members



Questions for CMAC members (1/2)

General question (slides 10–13)

a. What are your views on the areas for improvement to requirements on credit risk disclosures in IFRS 7, as suggested by the PIR feedback (slides 12-13)?

Questions on specific credit risk disclosures (slides 14–21)

If you have experience with these specific disclosures (eg for financial institutions):

b. Are disclosures about *sensitivity analysis* needed and how would you use it in your analyses?

c. What specific information about *post-model adjustments or management overlays* (PMAs) do you need for your analyses and how would you use that information in your analyses?

d. Do you find information about how entities determine *significant increases in credit risk* (SICR) useful? What specific improvements would you suggest, for example, a more useful summary of SICR drivers or other information?

Questions for CMAC members (2/2)

Potential areas for reduced disclosures (slides 22–25)

a. **What are your views on the potential areas for reduced disclosures, as suggested by the PIR feedback?**
   - Which IFRS 7 credit risk disclosures provided by non-financial institutions are most useful to you and why?
   - Do you currently use any of the disclosures described in slides 24–25 for your financial statement analyses and how?
   - What steps, if any, do you think the IASB could take to respond to the PIR feedback described in slide 24?

b. **Have you observed any other credit risk disclosure that, in your view, is not particularly useful and could be reduced?**
   - Are there any other disclosures that, in your view, do not provide useful information and why?

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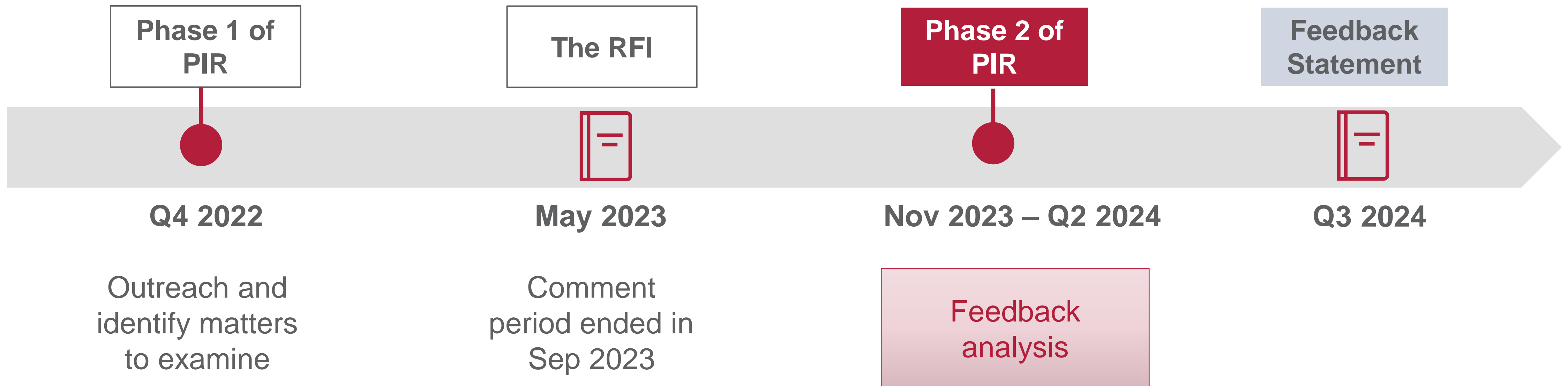
PIR—objective and process

Assess whether the **effects** of applying the requirements on users of financial statements, preparers, auditors and regulators are those the IASB **intended** when it developed the requirements

PIR of **impairment requirements** in IFRS 9 and **credit risk disclosure requirements** in IFRS 7



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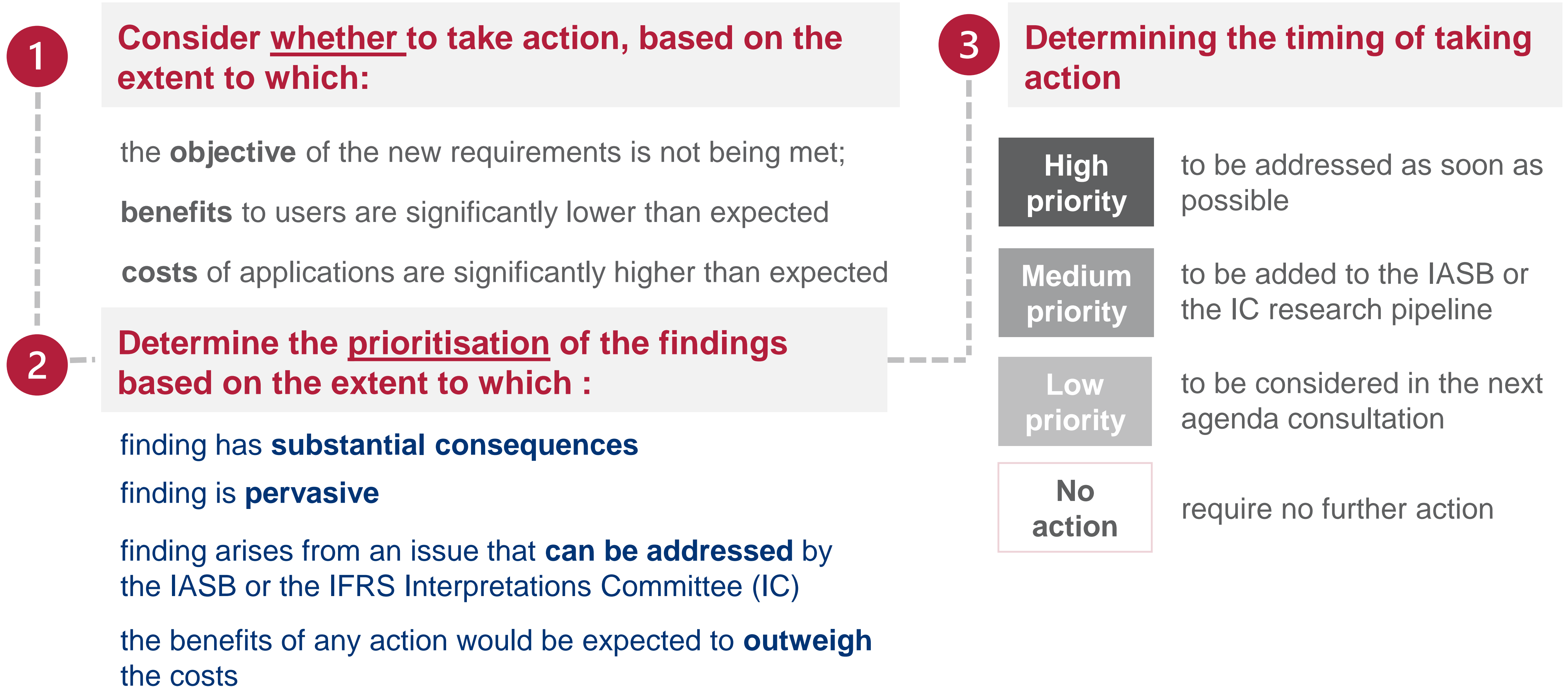
PIR—how does the IASB respond to findings?



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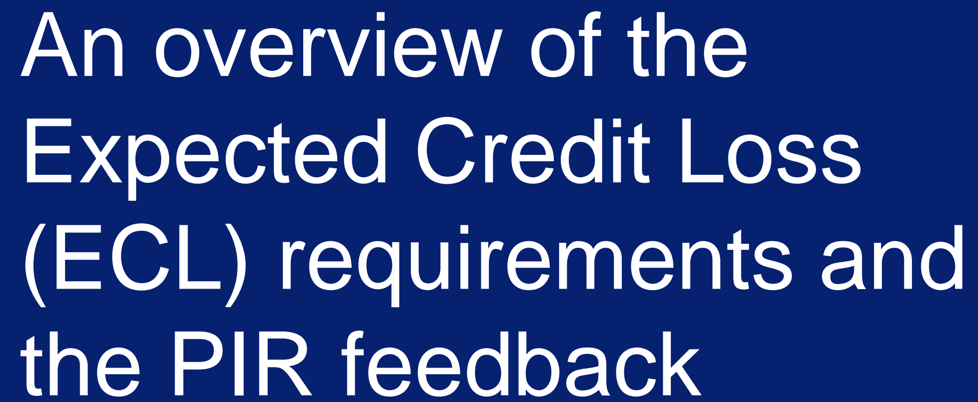


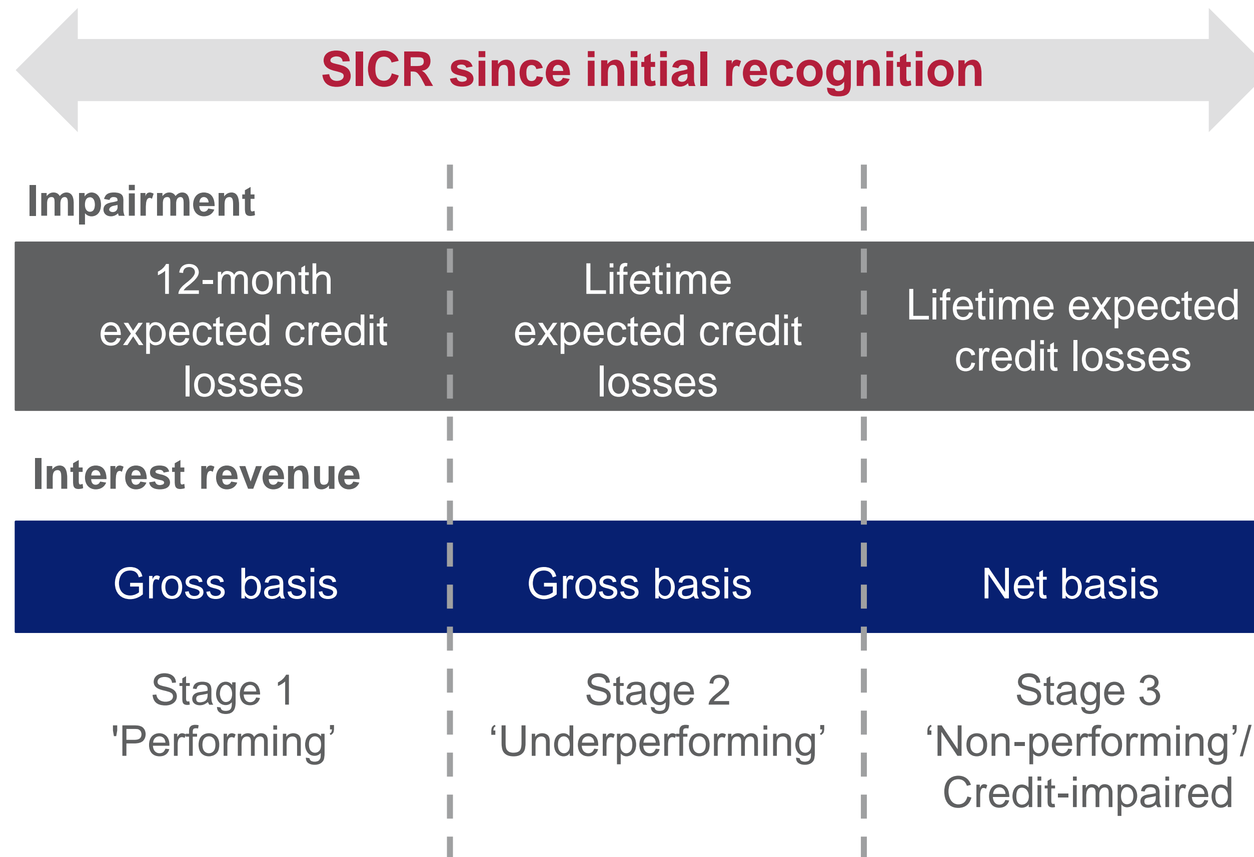
Overview of the ECL model

12-month ECL:

- are expected shortfall in all contractual cash flows given probability of default occurring in next 12 months

not

- expected cash shortfalls in next 12 months
- credit losses on assets expected to default in next 12 months



Lifetime ECL:

- result from all possible default events over the expected life of a financial instrument
- are weighted average credit losses with the probability of default as the weight
- are reflective of amount and timing—a loss arises even if the entity expects to be paid in full but later than contractually due

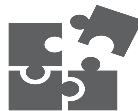
Overview of credit risk disclosure requirements in IFRS 7

Objective

Enable users to understand the **effect of credit risk** on the amount, timing and uncertainty of future cash flows

Entities' credit risk management practices and how they relate to recognition and measurement of ECL

Quantitative and qualitative information to evaluate amounts in the financials arising from ECL



Entities' credit risk exposure including significant credit risk concentrations

Amounts arising from ECL	• Reconciliation of the loss allowance • Significant changes in the gross carrying amounts contributing to changes in the loss allowance • Inputs and assumptions used to measure 12-month and lifetime ECL • Write-offs, modifications, collateral
Effect of deterioration, improvement in credit risk	• Carrying amount by credit risk rating grades • Inputs and assumptions used in determining whether SICR has occurred • Carrying amount of assets evaluated on individual basis

Overview of PIR feedback

Overall positive feedback

Almost all respondents said that the impairment requirements in IFRS 9:

- result in more timely recognition of credit losses compared to IAS 39
- work as intended with no fundamental questions ('fatal flaws')

Hot topics

- application challenges arising from the interaction between the impairment requirements and other IFRS 9 requirements on modification and derecognition
- diversity in the quality and granularity of **credit risk disclosures**

See slide 13

Other application matters

- estimating ECL for intragroup financial instruments and initial ECL for purchased financial assets
- measuring ECL using forward-looking scenarios, PMAs and reflecting the effect of financial guarantees in measuring ECL

Summary of PIR feedback on disclosures

Overall feedback

- no fatal flaws but some improvements are necessary
- most respondents requested more specific requirements to support greater consistency in disclosures
- some asked for improvements in specific disclosures, others suggested broader changes such as specify aggregation/disaggregation and the format of disclosures

Areas of diversity in disclosure

Main areas:

- sensitivity analysis
- PMAs
- determining SICR

Other areas, including:

- forward-looking scenarios, ECL reconciliation, or effect of climate related risks in ECL

Suggested improvements to IFRS 7

Add disclosure or guidance

- add minimum disclosure requirements
- specify the format for some disclosure
- provide application guidance and illustrative examples

Reduce some disclosures

- reduce some disclosure requirements, particularly for non-financial entities

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Background—Sensitivity analysis

- To determine the amount of ECL to recognise at each reporting date, an entity generally uses different and multiple inputs, assumptions and techniques. For example, an entity may use three economic scenarios (pessimistic, baseline and optimistic) and assign different weights to those scenarios to measure ECL allowance.
- To provide investors with information about how sensitive is that ECL allowance to the inputs, assumptions and techniques used, an entity decides to provide sensitivity analysis—ie disclose the effect on ECL allowance from applying different assumptions.

Illustration: A simplified example of a sensitivity analysis

Assumption	Change to current assumption	Increase/(decrease) in ECL allowance in CU millions
Weighting of pessimistic scenario (note 1)	Absolute increase of 10%	3.1
SICR criteria (note 2)	Relative reduction by 25%	1.7
Future house price inflation (note 3)	+ / - 0.5% pa	(0.7) / 0.7
Unemployment (note 4)	+ / - 0.5% pa	0.6 / (0.5)

Notes:

1. This sensitivity shows the impact of an increase of 10% to the probability weighting assigned to pessimistic scenario, from 35% to 45%, with a relative decrease to weighting for baseline and optimistic scenarios.
2. The impact of simultaneously reducing each multiplier threshold by 25%.
3. The impact if annual house price inflation in each future year was 0.5% higher or lower than assumptions applied.
4. The impact if unemployment rates in future year were 0.5% higher or lower.

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PIR feedback—Sensitivity analysis

IFRS requirements	PIR feedback	
	Identified problem	**Suggestions for improvement**
• IFRS 7 has no specific requirements to disclose information about the sensitivity of the ECL allowance to changes in key assumptions • IAS 1 provides general disclosure requirements over sources of estimation uncertainty	• some entities disclose a sensitivity analysis, while others do not disclose it • if disclosed, there are inconsistent disclosures among entities. For example, entities disclose ECL sensitivity based on scenario weightings, key macroeconomic variables, and other factors such as changes in probability of default, with different granularity	• most respondents suggested the IASB add requirements, eg disclose the effect on ECL allowance from applying a 100% weighting to different scenarios • some preparers are against more disclosure requirements, due to the costs from change

?

Are disclosures about sensitivity analysis necessary and how would you use that information in your analyses?

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Background—PMAs

What are PMAs?

The term 'post-model management adjustments or overlays' is not defined in IFRS 9 or in IFRS 7. In practice, it generally refers to all model overlays, management overlays, model overrides, or any other adjustments made to model output where risks and uncertainties are not adequately reflected in existing models.

Why do PMAs arise in practice?

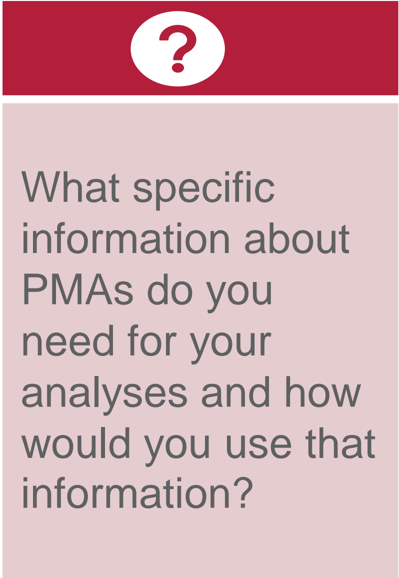
- The data used in statistical models, generally, includes historic information and reasonable and supportable information available about future forecast at the time of developing the models.
- However, circumstances emerge when statistical models cannot adequately capture all relevant information, risks and uncertainties on a timely basis—for example, during covid-19 pandemic.
- Therefore, PMAs generally arise to overcome the shortcomings of statistical models whereby historic information do not necessarily reflect the future outlook.

What is the problem?

- As explained in the next slide, stakeholders request more transparency around PMAs.

PIR feedback—PMAs

IFRS requirements	PIR feedback	
	Identified problem	**Suggestions for improvement**
• IFRS 9 sets out principles for the measurement of ECL, allowing an entity to determine the most appropriate techniques • IFRS 7 requires an entity to disclose the inputs, assumptions and estimation techniques used to measure ECL. Therefore, information about PMAs is required	• inconsistent disclosures on PMAs, even if material component of ECL allowance • lack of entity-specific information that would identify the material PMAs recognised, explain the reasons for using PMAs versus statistical models, and the plans to unwind PMAs, eg by embedding PMA related inputs into future statistical models	• most respondents suggested that the IASB add minimum disclosure requirements about PMAs • some respondents suggested that the IASB state explicitly that IFRS 7 requirements apply to PMAs



Background—SICR

- The IASB's objective of the impairment requirements is to capture lifetime ECL on all financial instruments that have SICR
- IFRS 9 has no bright lines and does not prescribe a specific or mechanistic approach to determine SICR. Nor does it mandate the use of an explicit probability of default to make this assessment. The appropriate approach will vary for different levels of sophistication of entities, the financial instrument and the availability of data

Why recognise lifetime ECL only after SICR?

- When credit is first extended, the initial creditworthiness of the borrower and initial expectations of credit losses are taken into account in determining acceptable pricing and other conditions
- A true economic loss arises when ECL exceed initial expectations (ie when the lender is not receiving compensation for the level of credit risk to which it is now exposed). Recognising lifetime ECL after a significant increase in credit risk better reflects that economic loss in the financial statements

Background—why do SICR disclosures matter?

IFRS 9 requirements

- The ECL model is a two-tier model, requiring an entity to measure the loss allowance for a financial instrument at an amount equal to:
  - **a. 12-month ECL**, if the credit risk on that financial instrument has not increased significantly since initial recognition; or
  - **b. lifetime ECL**, if the credit risk on that financial instrument has increased significantly since initial recognition.
- IFRS 9 provides well-described principles and presumptions, but it does not prescribe methods how to determine that a financial instrument has suffered SICR. Companies use those principles to align the accounting approach to their credit risk management practices.

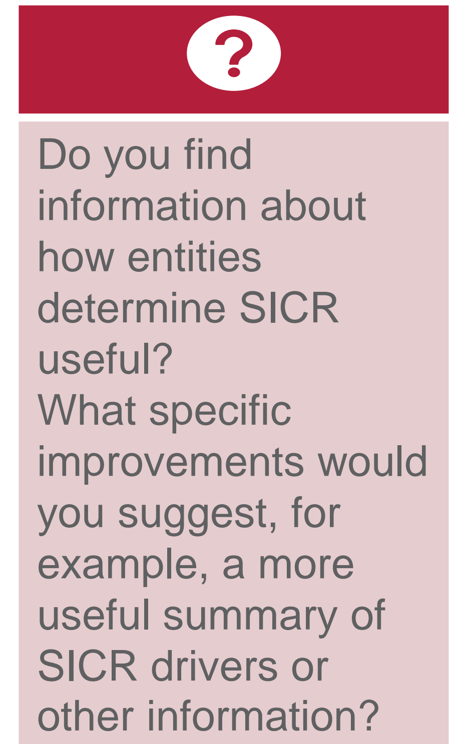
IFRS 7 requirements

IFRS 7 requires an entity to explain its credit risk management practices and how they relate to the recognition and measurement of ECL. The requirements include:

- how an entity determined whether the credit risk of financial instruments has increased significantly since initial recognition;
- an entity's definitions of default, including the reasons for selecting those definitions;
- how the instruments were grouped if ECL were measured on a collective basis; and
- how an entity determined that financial assets are credit-impaired financial assets.

PIR feedback—SICR

PIR feedback	
Identified problem	**Suggestions for improvement**
• determining SICR is the most judgemental area in the ECL model—it might result in delays in recognition of lifetime ECL if the approach used is not appropriate • lack of entity-specific information that explains the approach an entity uses, and most relevant factors it applied to determine if SICR occurred • inconsistency in disclosures—some entities disclose extensive quantitative and qualitative factors they used and disaggregate the information by class of assets; others provide generic descriptions of some factors without a clear link or proportionality to factors that triggered material changes in ECL	• most respondents suggested the IASB requires more specific information about SICR thresholds which trigger movements between stages, including the extent an entity relies on '30 days past due backstop' • some respondents called for minimum disclosures, with illustrative examples • others said more meaningful, rather than more information, about SICR thresholds is critical



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Background—Simplified approach

- To reduce the operational costs for entities with less sophisticated credit risk management systems, the IASB had developed the simplified approach for trade receivables, contract assets and lease receivables.
- Furthermore, IFRS 9 provides a number of practical expedients and simplifications to estimate ECL. An example of a practical expedient is the calculation of the ECL on trade receivables using a provision matrix.
- A provision matrix might, for example, specify fixed provision rates depending on the number of days that a trade receivable is past due (for example, 1 per cent if not past due, 2 per cent if less than 30 days past due etc)

Simplified approach

Lifetime ECL must be recognised for:

- Trade receivables & contract assets that **do not contain** a significant financing component
- Purchased or Originated Credit Impaired financial assets

Accounting policy election to always recognise lifetime ECL for:

- Trade receivables & contract assets that **contain** a significant financing component
- Lease receivables

PIR feedback indicates that most non-financial companies use the simplified approach, including the provision matrix

PIR feedback—Potential areas to reduce disclosures

PIR feedback

- Some respondents made general statements that the IFRS 7 requirements about credit risk disclosures are excessive for some entities, particularly non-financial entities.
- However, stakeholders did not always identify the potential areas to reduce disclosures and their rationale.
- A few said that the IASB should require less disclosures for trade receivables for which a simplified approach to ECL is applied (eg provision matrix illustrated on slide 25). These stakeholders consider that illustrating use of a provision matrix based on consolidated information is not useful to investors.
- Only a few stakeholders noted other areas for reduced requirements (even though detailed information or rationale were not provided)—those areas included:
  - reconciliation of movements in ECL during the period;
  - write-off policies or collateral management; and
  - scope out of disclosure requirements some instruments considered 'low credit risk', such as corporate bonds, sovereign debt or intragroup credit risk exposures.

Staff note
The assumption is that these disclosures would contain material information hence entities currently provide them in accordance with IFRS 7

Illustration: Disclosure of provision matrix for trade receivables

20XX CU'000	**Trade receivables days past due**				
	Current	**More than 30 days**	**More than 60 days**	**More than 90 days**	**Total**
Dealer financing					
ECL rate	0.10%	2%	5%	13%	
Estimated total gross carrying amount at default	CU20,777	CU1,416	CU673	CU235	CU23,101
Lifetime ECL—dealer financing	CU21	CU28	CU34	CU31	CU114
Customer financing					
ECL rate	0.20%	3%	8%	15%	
Estimated total gross carrying amount at default	CU19,222	CU2,010	CU301	CU154	CU21,687
Lifetime ECL— customer financing	CU38	CU60	CU24	CU23	CU145

Do you commonly analyse this type of disclosure and if so, do you find it useful?

If the disclosure is provided based on consolidated information—is the information still useful (eg if the ECL rates are given in a range)?

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6 Next steps

Next steps

Feedback analysis

- The IASB will be deliberating feedback on credit risk disclosures and potential actions, if any, in response to that feedback in Q2 2024.
- The input from CMAC members will be considered by the IASB as part of those deliberations.

Next milestone

To publish a feedback statement and project summary in Q3 2024.

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