IFRS Accounting

Staff paper

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Project	**Post-implementation Review of IFRS 9—Impairment**
Topic	**Analysis of outreach feedback—General model**
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Purpose and structure

1. This paper analyses feedback from outreach in phase 1 of the post-implementation review (PIR) of the expected credit losses (ECL) requirements in IFRS 9 *Financial Instruments*. Specifically, this paper summarises general feedback on the application of the ECL requirements, as well as specific feedback on the following areas of the requirements:

   (a) the general approach to recognition of ECL;

   (b) determining significant increases in credit risk; and

   (c) measurement of ECL;

2. This paper also provides staff analysis, recommendations, and questions for the IASB members on which matters to ask questions about in the Request for Information (RFI) for these areas.

3. Agenda Papers 27B–27C of this meeting provide the analysis of feedback on other areas of the requirements, including the credit risk disclosure requirements in IFRS 7 *Financial Instruments: Disclosures*.

Summary of staff recommendations

4. The staff recommend the IASB ask questions in the RFI about the following matters:

   (a) *the general approach to recognition of ECL:*

      (i) whether the overall objective of the requirements is being met and whether applying the general approach results in an entity providing useful information to the users of the financial statements about changes in credit risk; and

      (ii) the costs and benefits of applying the approach to particular transactions such as inter-company loans.

   (b) *determining significant increases in credit risk:*

      (i) application of judgement in determining significant increases in credit risk; and

      (ii) specific matters that give rise to diversity in practice, the root cause of that diversity, how pervasive it is and the effects of the diversity.

   (c) *measurement of ECL:*

      (i) forward-looking scenarios; and

      (ii) measuring ECL in periods of enhanced economic uncertainty, including the use of post-model management adjustments or overlays.

Questions for the IASB

Questions for the IASB
1. Do IASB members agree with the staff recommendations in paragraph 4 of this paper? 2. Are there any additional matters that the IASB should ask questions about in the Request for Information?

Summary of general feedback

5. Overall, stakeholders expressed positive views about application of the ECL requirements and said that generally the requirements are working well in practice, including in periods of enhanced economic uncertainty such as during the covid-19 pandemic. Most stakeholders specifically commented that:

   (a) the forward-looking ECL model in IFRS 9 results in a more timely recognition of credit losses than the incurred loss model in IAS 39 *Financial Instruments: Recognition and Measurement* and that it has addressed the problem of recognising loan loss allowances 'too little, too late'. This is consistent with the academic research findings summarised in Agenda Paper 27D of this meeting.

   (b) there are no fundamental questions about the objectives and principles of the requirements. Many stakeholders said the application of the ECL requirements during periods of economic stress such as covid-19 pandemic demonstrated that the principles are appropriate. Most feedback received during outreach related to application matters for particular areas.

   (c) for many stakeholders the impact of the changes introduced by the ECL requirements has been significant, primarily due to broader range of data required, particularly forward-looking information. However, stakeholders noted that the requirements have ultimately resulted in improvements of entities' internal controls and alignment to credit risk management. Users of financial statements said they welcome incorporation of forward-looking information because it results in more useful information, including information of predictive value. This is consistent with the academic research findings summarised in Agenda Paper 27D of this meeting.

6. Nonetheless, stakeholders said they observe diversity in practice in how entities apply the ECL requirements, thus lack of comparability the ECL recognised by different entities and that is, at least in part, because of the high level of judgement involved. Users of financial statements also said there is a lack of consistency in the information

entities disclose about ECL, which reduces the comparability of disclosures across different entities.

7. Generally, the specific matters stakeholders suggest the IASB examines in the PIR (summarised in this paper and Agenda Papers 27B–27C of this meeting) are matters for which stakeholders think the IASB should consider:

   (a) whether a *specific area* of the requirements could benefit from additional application guidance (for example, by incorporating in IFRS 9 the conclusions reached by the IFRS Transition Resource Group for Impairment of Financial Instruments on a particular topic) or clarification to support consistent application; or

   (b) enhancing the disclosure requirements in IFRS 7 aimed at resolving the existing lack of consistency in the information entities provide about particular areas of the ECL requirements.

8. As summarised in this paper and Agenda Papers 27B–27C of this meeting, most stakeholders note diversity in practice in how entities apply the ECL requirements in particular areas. Whilst we agree that diversity in practice is not optimal, the IASB will need to consider the root cause and the effect of that diversity. Some diversity in practice might arise because entities adopt different credit risk management practices. Furthermore, even if some diversity in practice exists, the effect of that diversity may not always be a significant detriment to the usefulness of information provided to users of financial statements.

A. The general approach to recognition of ECL

Background

- To enable entities to provide useful information about changes in credit risk and the resulting economic losses, users of financial statements supported an impairment model that distinguishes between financial instruments for which credit risk has increased significantly since initial recognition and those for which it has not.
- The objective of the ECL model in IFRS 9 is to be responsive to changes in credit risk and economic conditions. It requires entities to recognise expected credit losses at all times and to update the amount of expected credit losses recognised at each reporting date to reflect changes in the credit risk by recognising:

  (a) a loss allowance at an amount equal to at least 12-month ECL throughout the life of the instrument; and

  (b) lifetime ECL when there has been a significant increase in credit risk (SICR) since initial recognition.

Why recognise lifetime expected credit losses only after SICR?[1]

- When credit is first extended, the initial creditworthiness of the borrower and initial expectations of credit losses are taken into account in determining pricing and other conditions of the financial instrument.
- A true economic loss arises when expected credit losses 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.

[1] Paragraphs BC5.143–BC5.153 of the Basis for Conclusions on IFRS 9 explain the IASB’s rationale regarding the timing of recognition of lifetime ECL.

Overview of feedback

9. Almost all stakeholders said that the general approach to recognition of ECL is well understood and generally works well in practice. This included some users of financial statements who said they prefer the two-step approach of the ECL model—that is, recognising 12-month ECL and then lifetime ECL when the instrument experiences SICR—for the reasons outlined in the background section. However, a few preparers in jurisdictions where companies prepare financial statements applying both IFRS Accounting Standards and US Generally Accepted Accounting Principles, expressed their preference for convergence whereby the ECL model would require only lifetime ECL for simplicity purposes. In their view, a full lifetime ECL model would require entities to apply less judgement.

10. Some stakeholders expressed views or identified specific issues related to the general approach to recognition of ECL, namely:

    (a) a few stakeholders expressed the view that recognising ECL for financial assets that have recently been acquired by an entity at fair value results in overstatement of ECL and understatement of the value of the acquired assets, thus reducing the value of the investment. In particular, the initial carrying amount of the acquired financial assets could be below their fair value—in context of acquisition of portfolio of assets after their origination or business combinations. A few auditors suggested the IASB resolve this issue by requiring entities to apply a credit-adjusted effective interest rate (EIR) to these assets, similar to purchased or originated credit-impaired assets.

    (b) a few stakeholders (academics and a national standard-setter) expressed the view that the ECL model is prone to procyclicality.[2] For example, at the onset of a crisis, applying the model could, in their view, depict a cliff effect in ECL amounts recognised due to a transfer of exposures from stage 1 (12-month ECL) to stage 2 or stage 3 (lifetime ECL) and thus, lead to a rise in capital

[2] Agenda Paper 27D of this meeting summarises academic literature review on application of ECL requirements.

requirements. However, a national standard-setter observed that this phenomenon was not widely observed during covid-19 pandemic because of the subsidies granted by governments to borrowers.

(c) a few corporate preparers said the costs and complexities of applying the general approach to inter-company loans (that is, lending between businesses under common control) exceed its benefits. They mentioned that inter-company loans are usually associated with a low risk of economic losses resulting from a default because the loans are between related parties and generally in non-commercial terms. As a result, they have very little data available on which to base the assessment of changes in credit risk or the measurement of ECL. As this issue is relevant to separate financial statements only, stakeholders suggest the IASB considers simplifying the ECL requirements for these assets.

Staff analysis and recommendations

11. We are encouraged that the preliminary feedback from stakeholders indicates the principles of the general approach in IFRS 9 for recognising ECL are generally working as the IASB intended. We do however acknowledge stakeholder feedback summarised in paragraph 10.

12. We note that the feedback about acquired assets relates to a matter the IASB had considered during development of IFRS 9. As explained in paragraphs BC5.195–BC5.199 of the Basis for Conclusions on IFRS 9, the requirement to recognise 12-month ECL is a *practical* approximation of calculating a credit-adjusted EIR—which in fact, the IASB had proposed in the 2009 Impairment Exposure Draft, but stakeholders rejected it considering the approach to be cost-ineffective.

13. With regards to stakeholders' comment on procyclicality, we note that paragraphs BC5.285–BC5.286 of the Basis for Conclusions on IFRS 9 explain that the objective of the ECL requirements is to faithfully represent the economic reality of expected credit losses in relation to the carrying amount of a financial asset. The requirements

in IFRS 9 are based on the information available at the reporting date and are designed to reflect economic reality, instead of adjusting the assumptions and inputs applied to achieve a counter–cyclical effect. This is consistent with the objective of general-purpose financial reporting.

14. In our view questions about whether the ECL requirements in IFRS 9 result in the recognition of a loss allowance that is procyclical or counter-cyclical, cannot be attributed to one root cause (such as the overall objective of the ECL model) but rather to how entities apply the requirements and exercise judgement in particular circumstances. We therefore do not recommend the IASB to ask question specific to this matter.

15. Consistent with the objective of a PIR and the IASB's objective for this review as described in Agenda Paper 27 of this meeting, we recommend the IASB ask in the RFI whether the overall objective of the requirements is being met and whether applying the general approach to ECL results in an entity providing useful information to the users of the financial statements about changes in credit risk.

16. In addition, we think gathering further information about particular circumstances where stakeholders think the application costs outweigh the benefits will help the IASB in assessing whether such costs are significantly greater than expected.

B. Determining significant increases in credit risk

Background

- The objective of the ECL requirements in IFRS 9 is to recognise lifetime ECL for those financial instruments for which there have been a SICR since initial recognition—whether assessed on an individual or collective basis.
- In assessing whether SICR occurred, an entity is required to consider all reasonable and supportable information that is available to an entity without undue cost or effort, including forward-looking information.
- IFRS 9 does not set bright lines or 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.
- IFRS 9 requires a relative approach, ie requires that entities assess *changes* since initial recognition in the risk of a default occurring over the expected life of a financial instrument. The assessment of SICR is therefore not an absolute assessment of credit risk at the reporting date.

Overview of feedback

17. Some stakeholders, including prudential regulators and standard-setters said they observe significant diversity in what entities consider to be a *significant* increase in credit risk. For example, some entities would define SICR as a decrease in internal credit ratings to a level below a specified threshold, while others as a decrease in the credit ratings by x number of notches since initial recognition. They said comparison of SICR approaches among entities is therefore limited.

18. In addition, stakeholders raised the following issues:

    (a) a few prudential regulators said the use of collective assessment for purposes of determining SICR, or any other approach that timely captures factors that would not be identified at an individual financial instrument level, remains very limited. They noted that even when collective assessments are applied, entities use different approaches and portfolio groupings, which reduce comparability.

(b) a few national standard-setters commented on the diversity in practice in relation to the definition of 'default'. In their view, because IFRS 9 does not define 'default' entities use different concepts such as regulatory or other definitions. They said this limits comparability between entities because if there is no consistency in what 'default' means, there can be no consistency in how entities determine a significant increase in the risk of that event occurring.

19. Some preparers on the other hand said that the principle-based requirements and ability to apply judgement in determining SICR allow them to better reflect their unique credit risk management practices. They said that although implementing requirements for determining SICR was initially challenging and costly, the ongoing application does not present significant issues, in part because it is now aligned with how they manage credit risk.

20. Stakeholders of all groups acknowledged that having principle-based requirements in this area remains fundamental and the ability to exercise judgement is necessary as circumstances might change. However, they suggested the IASB provide additional application guidance or illustrative examples in particular aspects of the requirements, to ensure more consistent application—for example, whether or when entities are required to perform collective assessment for credit exposures to vulnerable sectors. A prudential regulator said the IASB could also clarify whether entities are required to align their approaches to determining SICR with how they manage credit risk in practice.

21. Users of financial statements as well as other stakeholders said improving specificity of disclosure requirements about the quantitative and qualitative factors (ie triggers) entities consider in determining SICR could also help alleviate this issue. (See Agenda Paper 27C of this meeting for further details on disclosures).

Staff analysis and recommendations

22. We note that the feedback in this area highlights matters that require application of judgement and were deliberated by the IASB during the development of IFRS 9, particularly, in relation to the definition of *significant* increases in credit risk and the definition of 'default'. As noted in paragraphs BC5.159–BC5.168 of the Basis for Conclusions on IFRS 9, the IASB considered and decided to reject a number of alternative approaches for determining SICR, including an absolute level of credit risk, a change in the credit risk management objective, credit underwriting policies and counterparty assessment.

23. The IASB was asked to specify the extent of increases in credit risk that would constitute SICR. However, as explained in paragraph BC5.171 of the Basis for Conclusions on IFRS 9, it observed that entities manage credit risk in different ways, with different levels of sophistication and by using different information. Therefore, selecting a single percentage or measure to assess changes in credit risk, could not properly reflect the assessment of credit across entities, products and geographical regions. Because of the arbitrary nature of defining the extent of increases in credit risk, the IASB questioned whether such a perceived comparability would result in useful information.

24. The IASB noted that while an entity may apply various approaches when assessing SICR and different approaches for different financial instruments, it must always consider the *change* in the risk of default occurring *since initial recognition*, over the expected life of the financial instrument, by using reasonable and supportable information that is available without undue cost and effort that may affect credit risk. Doing so was aimed at improving the comparability of the requirements for financial instruments with different maturities and different initial credit risks.

25. We therefore continue to be of the view that *applied consistently* does not mean *applied identically*, in particular for assessments that are relative in nature such as a change in credit risk since initial recognition. As noted in paragraph 19, entities apply different credit risk management practices to manage financial assets. Their credit risk

analyses are multifactor and holistic; whether a specific factor is relevant, and its weight compared to other factors, will depend on the type of product, characteristics of the financial instruments and the borrower as well as the geographical region. As such, the fact that entities use different approaches when making their assessments does not necessarily indicate that the requirements are not being applied consistently. Rather, an indication of inconsistent application would be entities reaching different conclusions on the same set of facts and circumstances in the same context.

26. In our view, gathering further information about circumstances in which entities are unclear how to apply the requirements, including applying judgement, to determine SICR will help the IASB in assessing whether the effects of the requirements are as expected and whether requirements are capable of being applied consistently. In addition, for the IASB to make these assessments, we think it will be important to gather evidence on the root cause of the existing diversity in practice, how pervasive the diversity is and the effects of the diversity. Therefore, we recommend the IASB ask questions in the RFI to gather information and *evidence* on these matters.

C. Measurement of ECL

Background

– IFRS 9 requires measurement of ECL to reflect:

(a) an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes;

(b) the time value of money; and

(c) reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions.

– ECL is a probability-weighted estimate of credit losses *over the expected life* of the financial instrument.

Overview of feedback

27. Stakeholders said the requirements on measurement of ECL are generally working as intended. Although many stakeholders identified different application challenges on incorporation of forward-looking information, they acknowledged these challenges generally stem from the inherent difficulties of forecasting the future and modelling data, rather than arising from the requirements in IFRS 9.

28. However, stakeholders said they observed diversity in practice in how entities incorporate forward-looking information into the measurement of ECL. Most feedback on this area is related to:

    (a) forward-looking scenarios; and

    (b) post-model management adjustments or overlays.

Forward-looking scenarios

29. Many stakeholders commented about diversity in practice regarding:

    (a) the number of economic scenarios used;

    (b) the variables considered; and

    (c) the weightings attached to particular scenarios.

30. For example, stakeholders said that during the covid-19 pandemic, some entities increased the number of scenarios used from three to five to reflect a more pessimistic outlook while other entities continued to use a single scenario without any adjustment to reflect non-linearity between variables. Similar diversity was also observed in the more recent economic conditions, for example in how entities incorporate information about rising inflation and other costs. They said this diversity significantly reduces comparability of ECL across entities and results in increased enforcement and auditing costs.

31. Some stakeholders attributed the diversity in practice to the principle-based nature of the ECL model and expressed the view that the model allows too much flexibility

and/or application of judgement in this area. A few auditors said that application guidance highlighting the objective of scenario analyses and what should be captured through multiple economic scenarios would enhance consistent application. They said the discussions of the IFRS Transition Resource Group for Impairment of Financial Instruments on this topic included useful conclusions (ie emphasising the importance of capturing non-linearity) and the IASB could consider including those in IFRS 9.

32. Some stakeholders also expressed concerns about lack of clarity on whether, and if so how, entities should incorporate the effect of climate-related risks into the measurement of ECL, including in the forward-looking information and scenarios. Stakeholders suggest the IASB considers adding application guidance and illustrative examples to support consistent application.

Post-model management adjustments or overlays

33. Many stakeholders commented on the use of post-model management adjustments or overlays (PMAs).[3] Preparers said statistical models have limitations, particularly in current conditions where historical information continue to be non-reflective of the future economic outlook. Thus, in their view, PMAs are a necessary process for management to ensure their expectations about credit risk and ECL are appropriately reflected in the financial statements. Preparers also highlighted that although PMAs are outside of the general statistical model validation and monitoring processes, they are subject to high-quality governance and control assessments.

34. Other stakeholders, including prudential regulators and users of financial statements, said they understood the need for PMAs and welcomed the fact entities are reflecting expectations about credit losses in circumstances when statistical models fail to appropriately reflect reasonable and supportable information about credit losses. However, they expressed the following concerns:

[3] The term 'post-model management adjustments or overlays' 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.

(a) PMAs have become increasingly common, and their size has continuously increased since the covid-19 pandemic. They involve subjective assessments and thus, they vary significantly amongst entities; and

(b) overall, there is lack of appropriate, and entity-specific, information in the financial statements that would explain the risks covered by PMAs and why statistical models do not provide for those risks. These stakeholders also noted lack of information about managements' plans to incorporate information in their statistical models thereby reducing their reliance on PMAs. For example, they observed that some entities 'repurpose' PMAs previously recognised for the effects of covid-19 pandemic to now provide for the effects of geo-political developments or inflationary pressures.

35. Noting that many entities are making use of PMAs, rather than statistical models, to reflect the future economic uncertainties, a few stakeholders were of the view that this questions whether the ECL requirements in IFRS 9 are working as intended. In their view, IFRS 9 does not necessarily contemplate the use of PMAs. They also expressed concerns relating to the quality of governance and documentation on PMAs relative to the statistical modelling outputs.

Staff analysis and recommendations

Forward-looking scenarios

36. Stakeholders' feedback indicates concerns about the level of subjectivity and diversity in practice in how forward-looking information is incorporated in the measurement of ECL, which affects the amount of ECL recognised by different entities.

37. As noted in paragraph BCE.111 of the Basis for Conclusions on IFRS 9, the IASB acknowledged that the more judgement that is required in the application of an ECL approach, the more subjective the estimates will be, and that this subjectivity will affect the comparability of reported amounts between different entities. Nonetheless, the IASB:

(a) considered that the ECL model will improve the comparability of reported amounts, despite the concerns about the application of judgement. This is because under the incurred loss model in accordance with IAS 39, increases in credit risk were not reported in the absence of a loss event, which limited the comparability of the reported amounts and the effective return on the financial assets. In addition, in practice, the point at which losses were considered to be *incurred* varied between entities.

(b) noted both qualitative and quantitative disclosures would be necessary to assist users of financial statements in understanding and comparing different measures of expected credit losses. Consequently, IFRS 7 requires disclosures about *inputs, assumptions and techniques* applied to measure ECL. Comparing those elements—rather than the total ECL reported—was intended to assist users of financial statements in assessing the appropriateness of the ECL amounts reported, between different reporting periods and different entities.

38. Some stakeholders perceive too much judgement is allowed in determining when multiple scenario analyses are relevant and what needs to be achieved with such analysis, thus additional clarity is needed to enhance consistent application. Therefore, in our view, gathering further information about circumstances in which entities are unclear, or are required to apply significant judgement, to determine whether multiple forward-looking scenarios are required will help the IASB in assessing whether the requirements are capable of being applied consistently.

39. Furthermore, we think it would be helpful to ask stakeholders about the root cause for the diversity in practice in this area. This will assist the IASB in understanding to what extent diversity is attributable to lack of clarity about the underlying objectives and principles of the ECL measurement requirements compared to circumstances where diversity is stemming from entities' credit risk management practices or other factors.

Post-model management adjustments or overlays

40. We acknowledge stakeholders' concerns about PMAs and the *quality* of information, governance and documentation thereof. However, in our view, those concerns do not necessarily stem from the requirements of IFRS 9. Entities use PMAs to overcome the limitations of statistical models. For example, when there is lack of sufficiently granular information to be modelled through statistical models or lack of resources to add additional scenarios (ie more pessimistic) to provide for future uncertainties.

41. Section 5.5 of IFRS 9 sets out the objectives for the measurement of ECL, allowing entities to decide the most appropriate techniques to satisfy those objectives. Thus, IFRS 9 does not prescribe particular approaches, nor does it require information to necessarily flow through a statistical model or credit-rating process in order to determine whether it is reasonable and supportable for use in measurement of ECL. As explained in paragraph BC5.265 of the Basis for Conclusions on IFRS 9, an entity can use a variety of techniques to meet the objective of an expected value for credit losses without requiring detailed statistical models.

42. We therefore do not agree with the perception of a few stakeholders that the use of PMAs may somehow indicate the ECL model is not working as intended. To the contrary, in our view, making appropriate use of PMAs to ensure ECL reflects actual expectations about credit losses is consistent with the objective of ECL model.[4] This is because, IFRS 9 requires entities to adjust their approaches to forecasting and measuring ECL to reflect *reasonable and supportable information available*—historic, current and forward-looking to the extent possible.

43. However, we acknowledge stakeholders' feedback about the significant diversity in practice in how entities use PMAs—some entities recognise PMAs to provide for specific risks not adequately captured by statistical models and hence are able to granularly attribute PMAs to a specific scenario or segment. Other entities use PMAs

[4] This is consistent with the educational material on applying IFRS 9 in the light of covid-19 pandemic. It is also consistent with regulatory reports about the application of the ECL requirements in IFRS 9.

as a 'general overlay' to adjust the total ECL amount recognised so that defined coverage ratios are achieved.

44. In our view, gathering further information on PMAs will help the IASB understand whether the measurement requirements are working as intended and are capable of being applied consistently. Therefore, we recommend the IASB ask questions in the RFI on this matter. For example, we think it would be helpful to ask stakeholders whether they think the requirements are clear and there is sufficient application guidance to allow entities to timely reflect changes in economic conditions into the measurement of ECL, including in periods of enhanced economic uncertainty—using statistical models or PMAs.

45. We note that, when discussing PMAs, many stakeholders focused on feedback about applying the ECL model in periods of economic stress and uncertainty. However, we note that ECL is about the credit losses expected *over the life* of a financial instrument. This means, consideration should not only be given to economic deterioration, but also to expected improvements over the life of the instrument.

46. Please see Agenda Paper 27C of this meeting for the analysis of feedback on disclosures about PMAs.