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Ref: EFRAG's due process on the IASB's Request for Information on the Post Implementation Review of IFRS 9 – Impairment

Dear Dr Klinz,

The European Securities and Markets Authority (ESMA) thanks you for the opportunity to contribute to EFRAG's due process with regards to the IASB's Post Implementation Review (PIR) of IFRS 9 *Financial Instruments* Impairment. We are pleased to provide you with the following comments with the aim of improving the consistent application and enforceability of IFRS in the European Union.

ESMA strongly supports PIRs as an opportunity to assess how issuers apply in their financial statements the IFRS requirements and how these can be further improved to address any issues that may challenge consistent application, enforceability and usefulness to users of financial statements.

Our answers to the IASB's Request for Information (RFI) included in Appendix to this letter are based on the evidence from supervision and enforcement activities undertaken by European enforcers on financial statements. We refer in particular to ESMA's Report on the application of the IFRS 7 and IFRS 9 requirements regarding banks' expected credit losses (ECL).[1]

ESMA generally agrees that the impairment-related requirements in IFRS 9 and IFRS 7 resulted in providing useful information to users of financial statements about the effect of credit risk on the amount, timing and uncertainty of future cash flows. At the same time, ESMA considers that more detailed guidance and additional explanations would contribute to the improvement in the level of compliance, comparability and transparency in the application of the requirements by entities, resulting in more relevant, reliable and comparable information on the impact of credit risk.

In particular, ESMA considers that the consistency of application of the significant increase in credit risk (SICR) assessment could be increased by providing additional guidance on the determination of thresholds triggering the recognition of SICR and on the collective SICR assessment (e.g., better explaining the use of the top down and bottom-up approaches).

[1] ESMA32-339-169 Report - On the application of the IFRS 7 and IFRS 9 requirements regarding banks' expected credit losses (ECL), 15 December 2021.

ESMA observes that the methodology and procedures for calculation and release of overlays are very heterogeneous in current practice. Given the wide use of management overlays in practice, it would be helpful to clarify that overlays should be directionally consistent with objective and verifiable evidence and should be applied at the most granular level possible.

ESMA would find it helpful if the IASB could provide additional guidance on when the cash flows expected from credit enhancements (e.g., financial guarantees) should be reflected in the estimate of expected cash shortfalls for the purpose of measuring ECL, as this is not always very clear in practice.

With regard to the application of impairment requirements in IFRS 9 with other requirements, ESMA highlights existing unclarities concerning the interplay of impairment requirements and requirements on modification of financial assets.

Finally, ESMA considers that the level of comparability of credit risk disclosures can be increased to achieve an appropriate balance between comparable information and relevant information. In particular, ESMA sees merit in providing additional guidance and/or examples in the following disclosure areas:

- management overlays,
- significant increase in credit risk,
- sensitivity analysis,
- effect of climate-related risk on the ECL measurement,
- forward-looking information, and
- changes in loss allowances.

In case you have any questions or comments please do not hesitate to contact me or Isabelle Grauer-Gaynor, Head of the Corporate Finance and Reporting Unit (Isabelle.Grauer-Gaynor@esma.europa.eu).

Yours sincerely,

[signed]

Verena Ross

Appendix

Question 1 – Impairment
Do the impairment requirements in IFRS 9 result in: **a) more timely recognition of credit losses compared to IAS 39 and address the complexity caused by having multiple impairment models for financial instruments? Why or why not?** **b) an entity providing useful information to users of financial statement about the effect of credit risk on the amount, timing and uncertainty of future cash flows? Why or why not?**

1. ESMA noted that the review of the academic literature conducted by the IASB staff for the purposes of this PIR showed that researchers generally agree that applying the ECL model resulted in more timely recognition of allowances for credit losses, as evidenced in particular by an increase in the positive association between allowances for credit losses in the current period and non-performing loans in the next period. This is consistent with ESMA's expectations that the move from the incurred loss model in IAS 39 to the ECL model in IFRS 9 would result in earlier recognition of credit losses. Based on supervision and enforcement activities undertaken by European enforcers, ESMA has found no evidence to contradict this finding. However, ESMA notes that a recent analysis conducted by the ECB based on information about loans from 1,721 European banks indicates that, despite higher level of provisioning under IFRS 9, the bulk of provisioning for the average loan still occurs at or after default.[2]

2. ESMA generally agrees that the impairment requirements in IFRS 9 resulted in providing useful information to users of financial statements about the effect of credit risk on the amount, timing and uncertainty of future cash flows. At the same time, ESMA considers that more detailed guidance and additional explanations in IFRS 9 and IFRS 7 can contribute to the improvement in the level of compliance, comparability and transparency in the application of the requirements by entities. For more details, please refer to our answers to other questions.

[2] ECB, Financial Stability Review, May 2023

Question 2 – The general approach to recognising expected credit losses

(a) **Are there fundamental questions (fatal flaws) about the general approach? If yes, what are those fundamental questions?**

(b) **Are the costs of applying the general approach and auditing and enforcing its application significantly greater than expected? Are the benefits to users significantly lower than expected?**

3. ESMA considers that the recognition of at least 12-month ECL throughout the life of the instrument and of lifetime expected credit losses when a significant increase in credit risk occurs provides useful information about changes in credit risk and resulting economic losses. The two-step model gives an appropriate approximation of the economic ECL without excessive operational complexity.

Question 3 – Determining significant increases in credit risk

(a) **Are there fundamental questions (fatal flaws) about the assessment of significant increases in credit risk? If yes, what are those fundamental questions?**

(b) **Can the assessment of significant increases in credit risk be applied consistently? Why or why not?**

4. ESMA considers the principle-based approach to assessing SICR used in IFRS 9 to be generally appropriate, even though it requires entities to exercise a significant degree judgement. However, ESMA considers that the consistency of application of the SICR-assessment could be increased by providing additional guidance in IFRS 9.

5. ESMA notes that paragraph B5.5.9 of IFRS 9 explains that significance of a change in credit risk depends on the risk of a default occurring as at initial recognition. According to paragraph B5.5.11, SICR generally cannot be assessed simply by comparing the change in the absolute risk of a default occurring over time.[3] ESMA understands that some financial institutions use a combination of the relative and absolute thresholds to assess SICR and sees therefore merit in clarification whether this approach is allowed under IFRS 9. ESMA considers that the use of this approach should be limited to setting a minimum absolute increase in the probability of default (PD) to avoid very high-quality assets moving to stage 2 as a result of a very small absolute PD change.

6. ESMA considers that additional guidance on the determination of SICR thresholds would be useful. This may include clarification that relative SICR thresholds should be defined in an unbiased manner. In particular, they should be consistent across portfolios and do not systematically favour riskier borrowers (an example of a systematic favouritism is implementation higher relative stage transfer thresholds which are applied to debtors with

[3] As explained by the IASB, the use of the absolute thresholds is acceptable for portfolios of financial instruments with similar credit risk at initial recognition (paragraph BC5.161 of IFRS 9 Basis for Conclusions).

generally higher PDs, worse ratings at origination or more volatile rating migrations). Moreover, determining ex ante a desired percentage of the loan book that should be allocated in stage 2 in the long run or by defining stage transfer thresholds based on predefined quantiles of historical distributions of changes in probabilities of default or rating (so-called "quantile approach") should explicitly not be allowed.[4]

7. Finally, ESMA encourages the IASB to provide additional guidance on the application of the collective SICR assessment. In particular, explanations on the bottom up and top-down approaches, the application of which is currently only shown in the Illustrative Examples accompanying IFRS 9 (paragraphs IE38 and IE39), could be included in the standard. With respect to the top-down approach, it could be clarified that entities may rely on analytical approaches to systematically determine which portions of a portfolio have not experienced a SICR (e.g. by using representative migration tables conditioned on the state of the economy if individual ratings are not available).

Question 4 – Measuring expected credit losses

a) Are there fundamental questions (fatal flaws) about requirements for measuring expected credit losses? If yes, what are those fundamental questions?

b) Can the measurement requirements be applied consistently? Why or why not?

8. While ESMA considers that the requirements for measuring ECL in general achieve the objective of providing users of financial statements with useful information about the amount, timing and uncertainty of an entity's future cash flows, improvements can be made in some areas through additional guidance in IFRS 9.

9. ESMA notes that material adjustments in the form of management overlays are increasingly used in practice by banks. The discretionary and exceptional interventions in model-based calculations of ECL, including updates of the model inputs (so-called "in-model adjustments"), or applied completely outside the primary models ("post-model adjustments"), make up a significant proportion of the credit risk allowances of many credit institutions.

10. Management overlays are often used to compensate for the lack of historical data, which is needed for ECL modelling with respect to sudden and previously unobserved (novel) risk factors. During the COVID-19 pandemic in 2020 and afterwards, banks faced the challenge of estimating the extent of the possible economic slump as a result of lockdowns and the associated loan losses in their portfolios. This uncertainty in an unprecedented economic environment could be captured only to a limited extent by the applied ECL models, as there was no robust data history for comparable events regarding the central input model-

[4] In this approach, the issuer identifies ex-ante a certain quantile (X%) of the historical distribution. The relative change in probability of default corresponding to this quantile of the distribution then represents the quantitative threshold of SICR. This approach should not be confused with the evidence-based determination of a proportion of the overall portfolio that has significantly increased credit risk (top-down approach).

parameters such as PD and LGD. At the same time, the significant more recent events (such as high inflation rates, the sharp rise in interest rates, the development of energy prices or supply chain problems and country risks due to the Russian invasion of Ukraine) that were not observable in the recent data history, led to uncertainties that cannot be covered by ECL-models, so that banks were again dependent on the use of overlays. Moreover, the need for overlays is likely to persist in the future (e.g., to capture environmental risks as long as there are no appropriate approaches for modelling this risks).

11. ESMA observes that the methodology and procedures for calculation and release of overlays are very heterogeneous in current practice. They are occasionally based on stress tests for vulnerable sectors, simulations and sensitivity analyses or cumulative rating downgrades for segments that are particularly affected. Some banks still use expert judgements based on little evidence to cover novel risk factors.

12. Therefore, ESMA agrees with the stakeholders who have expressed concerns about the high level of subjective management assessments related to management overlays and considers it would be helpful, given their wide use in practice, to include explanations in IFRS 9 on the use of management overlays, particularly on emphasising the need for consistency with objective and verifiable evidence (e.g. observable macroeconomic variables and forward-looking forecasts). Furthermore, possible effects on stage transfers should be taken into consideration. It could also be outlined that novel risks may be taken into account applying the top-down approach, by first quantifying the risks at a sectoral level and then identifying which groups of clients are affected by each novel risk.[5] ESMA also considers that the inclusion of practical examples of management overlays would be very useful. We also refer to our comments on Question 9 regarding the disclosures on management overlays.

13. Moreover, ESMA would find it helpful if the IASB could provide additional guidance on when the cash flows expected from credit enhancements (e.g., financial guarantees) should be reflected in the estimate of expected cash shortfalls for the purpose of measuring ECL, as this is not always very clear in practice. This relates to the cases where credit enhancement is not explicitly mentioned in the contractual terms. For example, in one case discussed by European enforcers, an entity provided loans that were financed through the issuance of debt instruments (debentures) that include a repayment clause according to which the entity's obligation to repay the respective debenture was limited to the actual cash flow received from the related loans. The issuer argued that the repayment clause is in substance a credit enhancement to the loans and should be considered as a financial guarantee in accordance with paragraph B5.5.55. [6]

14. According to paragraph B5.5.55 of IFRS 9, credit enhancements can only be taken into account when estimating expected cash shortfalls if credit enhancements are part of the

[5] See our comments to Question 3.

[6] Decision ref EECS/0122-01 in 26th Extract from the EECS's Database of Enforcement. The enforcer did not agree with the issuer's argumentation.

contractual terms and are not recognised separately by the entity. ESMA notes that the March 2019 IFRIC Update mentions that the Transition Resource Group for Impairment of Financial Instruments (ITG) discussed in December 2015 what is meant by 'part of the contractual terms' in paragraph B5.5.55. The ITG observed in particular that credit enhancements included in the measurement of ECL should not be limited to those that are explicitly part of the contractual terms and the entity should apply its judgement in assessing whether a credit enhancement is integral to the contractual terms considering all relevant facts and circumstances. ESMA would welcome additional guidance in IFRS 9 on how to apply this judgement.

15. Moreover, ESMA considers that it would be useful to provide more clarity in IFRS 9 on when entities should perform the 12-month ECL assessment of a stage 1 financial asset on an individual assessment basis. Enforcers discussed a case where a bank measured ECL exclusively on a collective basis for all stage 1 financial assets. ESMA notes in this context that the measurement of lifetime ECL should be performed on an individual basis when the entity has reasonable and supportable information that is available without undue cost or effort (paragraph B5.5.4). As 12-month ECL are a portion of the lifetime ECL (paragraph B5.5.43), ESMA understands that this requirement also applies to the measurement of 12-month ECL. Although for retail loans with little or no updated credit risk information on an individual basis an individual assessment could be difficult (paragraph B5.5.3), for corporate loans of significant outstanding balance an individual assessment incorporating entity-specific credit-risk factors will most likely be necessary. In addition, it would be helpful to explain when a combination of an individual and a collective approach for the ECL measurement may be required and provide an example of how a combination of both approaches could be applied to a portfolio of financial instruments with different characteristics.

16. In addition, ESMA notes that environmental factors are increasingly considered material from a risk perspective and can as such have impact on the expected credit losses of many entities, especially in the financial sector. ESMA is aware that the IASB has recently started a maintenance project to explore whether and how companies' financial statement can provide better information about climate-related risks. While there is no doubt that under current impairment requirements, entities should consider environmental matters when the effect of those matters is material for their financial statements, ESMA encourages the IASB to explore (as part of this PIR or alternatively within its project on climate-related risks) whether specific guidance (i.e. examples) in IFRS 9 or educational material could be provided regarding the consideration of climate risks and other environmental aspects in measuring ECL. In particular, examples of in-model PD adjustments currently applied by some banks to account for the climate risk could be included (for example adjustments to PDs based on re-rating of clients assuming higher levies on carbon emissions or higher costs of natural resources consumption).

Question 5 – Simplified approach for trade receivables, contract assets and lease receivables
a) **Are there fundamental questions (fatal flaws) about the simplified approach? If yes, what are those fundamental questions?** b) **Are the costs of applying the simplified approach and auditing and enforcing its application significantly greater than expected? Are the benefits to users significantly lower than expected?**

17. ESMA does not have any comments on this question.

Question 6 – Purchased or originated credit-impaired financial assets
Can the requirements in IFRS 9 for purchased or originated credit-impaired financial assets be applied consistently? Why or why not?

18. ESMA does not have any comments on this question.

Question 7 – Application of the impairment requirements in IFRS 9 with other requirements
Is it clear how to apply the impairment requirements in IFRS 9 with other requirements in IFRS 9 or with the requirements in other IFRS Accounting Standards? If not, why not?

19. ESMA observes that unclarities exist regarding the interplay of impairment requirements and requirements on modification of financial assets. In particular, it is not entirely clear whether entities must distinguish and account differently for the modifications caused by a borrower's credit deterioration and modifications caused by other events (for example, changes in market conditions). Furthermore, in cases when a modification is caused by a borrower's credit deterioration, it seems unclear whether gains or losses should be presented in the impairment line item in the statement of profit or loss, or whether they should be accounted for as an adjustment to the gross carrying amount of the asset and presented in the statement of profit or loss, separately from the impairment line item.

Question 8 – Transition
Were the costs of applying the transition requirements and auditing and enforcing their application significantly greater than expected? Were the benefits to users significantly lower than expected?

20. ESMA does not have any comments on this question.

Question 9 – Credit risk disclosures

a) **Are there fundamental questions (fatal flaws) about the disclosure requirements in IFRS 7 for credit risk? If yes, what are those fundamental questions?**

b) **Are the costs of applying these disclosure requirements and auditing and enforcing their application significantly greater than expected? Are the benefits to users significantly lower than expected?**

21. ESMAs review of 2020 financial statements of a sample of 44 European banks has demonstrated that the ECL disclosures of these banks were not always comparable and provided different degrees of transparency (in particular, ESMA noted the lack of entity-specific details and of narrative explanations in some areas).

22. While ESMA considers that there is no single cause for the observed low level of comparability of the credit risk disclosures, as it is to certain extent due to different credit risk management approaches as well as partly, to shortcomings in the application of the current disclosure requirements, ESMA considers that the level of comparability can be increased by providing additional guidance and/or examples in the following areas:

    a) Management overlays

23. As indicated in the answer to Question 4 above, management overlays are widely used in practice by banks. Although management overlays are not specifically mentioned in IFRS 7, ESMA notes that the standard already includes provisions that require entities to provide details on rationale and methodology of material management overlays (paragraphs 35B(a), 35G, 35D and 35E), their quantitative effects (paragraphs 35B(b), 35H), whether they relate to a specific impairment stage (paragraph 35F(a)) or whether there were significant changes in methodologies and assumptions from the previous reporting period and the reasons for those changes (35G(c)).

24. However, to increase the level of comparability and transparency and enable users of financial statements to better understand the effect of credit risk on the amount, timing and uncertainty of future cash flows, it would be beneficial to clarify in IFRS 7 that

    - for each material management adjustment, information on its quantitative impact on the ECL estimate, the rationale and the methodology applied shall be provided,

    - a granular breakdown of the quantitative impact of the adjustments may be appropriate to meet the requirements of paragraph 35H of IFRS 7, and

    - the rationale shall clearly specify the reasons for the adjustment (e.g., to include the latest macroeconomic outlook, or to address model limitations resulting from insufficient inclusion of certain risks).

25. Moreover, entities should be required to provide information on whether the adjustments relate to a specific impairment stage and what impact they have on staging of the underlying instruments.

26. When providing information in accordance with paragraph 35G(c) of IFRS 7, entities should specifically be required to explain any significant changes in methodologies and assumptions from the previous reporting period related to management overlays and the reasons for those changes. This information should enable users to understand the extent of the movements, their nature (i.e., changes in underlining assumptions) and the reasons for the development of management overlays (i.e., incorporation of the post-model adjustments in the core model).

27. Finally, given the importance of management overlays for understanding the effect of credit risk, ESMA encourages the IASB to include illustrative examples or related disclosures.

b) Significant increase in credit risk (SICR)

28. Paragraphs 35F(a) and 35G(a)(ii) of IFRS 7 require entities to disclose credit risk management practices, the basis for the inputs and assumptions and the estimation techniques used to determine whether a SICR has occurred for financial instruments since their initial recognition or whether a financial asset is credit impaired. ESMA sees merit in a more specific guidance to explain the quantitative and qualitative factors applied by entities to identify SICR, including the length of the "cure" period, and any material differences in the application of the factors across portfolios. Moreover, on the basis of paragraph 35G(a)(ii) of IFRS 7 ESMA recommends requiring entities to provide information by classes of assets or portfolio types on quantitative SICR-thresholds for each SICR indicator applied, such as probability of default (PD), deterioration triggers and whether they are used to determinate absolute or relative variation, including explanations of any significant differences in thresholds depending on portfolio type. A disclosure on which specific factors caused the stage movements in the reporting period would also be useful for users of financial statements.

29. With respect to disclosures required by paragraph 35F(a)(i) of IFRS 7 on the application of the low credit risk expedient, it would be useful to clarify that issuers shall disclose the main types of transactions or portfolios that are impacted by these expedients, including qualitative and quantitative criteria used to define "low credit risk".

30. The requirement of paragraph 35F(c) of IFRS 7 to disclose how the instruments were grouped if expected credit losses were measured on a collective basis should be supplemented by disclosures regarding key risk characteristics underlining the grouping approach and whether a "bottom up" or "top down" approach was used.

c) Sensitivity analysis

31. IFRS 7 only requires specific sensitivity disclosures for market risks. ESMA considers that the wide use of sensitivity analyses by entities exposed to significant credit risk indicates

that these analyses are of particular importance to understand of the effect of credit risk on entities' financial statements. Therefore, ESMA recommends including guidance in IFRS 7 on providing disclosures on sensitivity analyses for the credit risk. Such guidance could include explanations on the types of sensitivity analyses (e.g., multi-factor vs. single factor) and specific information useful to users of financial statements (e.g. quantitative impact on staging). The inclusion of illustrative examples would also be very helpful. In particular, ESMA recommends including an example of a sensitivity analysis based on a 100% weighting of each macroeconomic scenario.

d) Effect of climate-related risk on the ECL measurement

32. In light of increasing importance of environmental factors (in particular climate-related risks) in the risk management of many entities materially exposed to credit risk (see our response to Question 4), ESMA recommends providing examples of disclosures (in IFRS 7 and supplementing educational material) on how climate-related risks are incorporated in the calculation of ECL, on credit risk concentrations related to environmental risks and how these risks affect the amounts recognised in the financial statements.

e) Forward-looking information

33. When explaining how forward-looking information was incorporated into the determination of ECL (including the use of macroeconomic information) as required by paragraph 35G(b) of IFRS 7, ESMA recommends that the IASB requires entities to provide more specific disclosures on the main judgements and estimations related to uncertainties that have been taken into account when defining the macroeconomic scenarios and their weight. In particular, entities shall disclose quantitative information on the macroeconomic variables considered for each scenario and main geographical areas and/or sectors as well as the methodology used to determine the relative weights of scenarios. ESMA considers this information useful taking into account that using scenario weightings that results in an estimate close to one (baseline) scenario may be of minor explanatory value.

f) Changes in loss allowances

34. Paragraphs 35H requires tabular reconciliations of the loss allowance from the opening balance to the closing balance. Paragraph 35I of IFRS 7 requires explanations of how significant changes in the gross carrying amount during the period contributed to changes in the loss allowance. To ensure better transparency, ESMA recommends requiring entities to provide a joint reconciliation of the loss allowance and the gross carrying amount.

Question 10 – Other matters

a) Are there any further matters that you think the IASB should examine as part of the post-implementation review of the impairment requirements in IFRS 9? If yes, what are those matters and why should they be examined?

b) Do you have any feedback on the understandability and accessibility of the impairment requirements in IFRS 9 that the IASB could consider in developing its future IFRS Accounting Standards?

35. ESMA does not have any comments on this question.