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<u>Comments on “Post-Implementation Review of IFRS 9 – Impairment”</u>

Dear Madam, dear Sir,

On behalf of the Austrian Financial Reporting and Auditing Committee (AFRAC), the privately organised standard-setting body for financial reporting and auditing standards in Austria, we appreciate the opportunity to comment on the request for information “Post-Implementation Review of IFRS 9 – Impairment (Mai 2023). Principal authors of this comment letter were Gerhard Margetich, Peter Bitzyk, Iryna Bura, Stephan Kinsele, Philip Kudrna, Roland Nessmann, Ernst Schönhuber and Maria Sumerauer. In order to ensure a balanced Austrian view on the request for information, the professional background of these authors is diverse and includes preparers, auditors and academics.

Best regards,
Romuald Bertl
Chairman

<u>Comments on "Post-Implementation Review of IFRS 9 – Impairment"</u>

General comments

AFRAC believes that the impairment requirements outlined in IFRS 9 are generally working as expected. This perspective is supported by feedback gathered from constituents during the preparatory work conducted for this Comment Letter. The feedback shows that the use of the forward-looking expected credit loss (ECL) model leads to a prompter recognition of credit losses as compared to the application of IAS 39, thus, effectively addressing the issue of delayed credit loss recognition in a normal economic cycle. However, AFRAC observed that the recent economic crises revealed some weaknesses of the impairment model to reflect external shocks or unforeseen rapid changes in the economy. These weaknesses led to a widespread use of post-model adjustments.

Specific comments

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 statements about the effect of credit risk on the amount, timing and uncertainty of future cash flows? Why or why not?**

In principle, the combination of the impairment requirements in IFRS 9 and the disclosure requirements in IFRS 7 provide valuable information to users of financial statements about the impact of credit risk on the amount, timing, and uncertainty of future cash flows. However, AFRAC identified certain application issues and diversity in practice that require further examination in the IASB's post-implementation review (PIR). Feedback gathered by AFRAC suggests uncertainties regarding the following aspects of the application of the standard:

Necessity to use extensive post-model adjustments (also called management overlays)

AFRAC believes that the basic concept of IFRS 9 was designed to reflect changes in credit risk through a standard life cycle in a normal economic cycle. However, the concept of "forward-looking information" did not prove adequate in order to cope with rapid changes and external shocks in turbulent times. Therefore, preparers made extensive use of post-model adjustments, which were only a side aspect in the basic concept of IFRS 9, in order to correctly and timely recognise credit losses.

Feedback obtained suggests that post-model adjustments have a significant impact on ECL in practice, however, their application and disclosure is not clearly specified in the standard. AFRAC observed that many preparers struggle to include post-model adjustments into their ECL scenario analyses. An inclusion of different scenarios of post-model adjustments might improve the usefulness of the financial reporting but would increase the cost of preparers significantly.

Additionally, there is uncertainty about how to incorporate long-term risks in forward-looking information (and thus also post-model adjustments) as well as the differentiation between long-term risks and trends from operating risks or general business risks.

Interaction between modification, impairment, and derecognition requirements

AFRAC believes that there is a need for clearer guidance on how the requirements for modification, impairment, and derecognition are supposed to interact within IFRS 9. The application of accounting effects over these three events, and their subsequent presentation in the profit or loss statement is currently influenced by various factors and interpretations. These include the reasons behind the modification and/or derecognition, such as commercial opportunities or the borrower's financial difficulties, as well as the sequence in which an entity considers these different elements. As a result, AFRAC suggests that the IASB should provide clearer instructions on how the requirements for modification, impairment, and derecognition interrelate and should be applied.

ECL measurement based on expected concession that is not related to the credit risk

AFRAC has noted that there is a range of different application practices concerning the extent to which cash shortfalls should be factored into the calculation of Expected Credit Losses (ECL). Specifically, the IFRS Interpretation Committee's Agenda Decision approved in October 2022 and titled "Lessor Forgiveness of Lease Payments" (pertaining to IFRS 9 and IFRS 16) generated uncertainty concerning the limits of credit risk. AFRAC observes that this Agenda Decision could have broader implications beyond lease receivables, potentially causing unintended implications for established general accounting practices for financial assets. Consequently, AFRAC suggests that the IASB should clarify whether the phrase "all cash shortfalls" used in the Agenda Decision should be interpreted within the context of concessions made by the lender due to the borrower's financial difficulties and how ECL measurement based on expected concession has to be seen in the context of modification and derecognition.

Credit risk disclosures

AFRAC has observed diversity concerning the level of detail and content in disclosures provided by reporting entities. This diversity in practice leads to less comparable financial disclosures. The measurement guidelines laid out in the standard offer room for interpretation, as shown by a variety of different applications by the reporting entities. The disclosure requirements often lead to an abundance of information, which is difficult to be interpreted. While AFRAC's constituents generally approve of the quantity of disclosure, the quality could be improved by stricter guidelines, which should lead to an increase of comparability and additional qualitative explanations.

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?

Exposures in stage 1 and stage 2 simultaneously:

IFRS 9 requires an entity to assess the significant increases in credit risk (SICR) on an instrument-by-instrument basis, rather than based on the parties involved in the underlying contract. According to reports from AFRAC's constituents, it is not unusual for an entity to have certain financial assets in stage 1, while other similar financial assets with the same counterparty, held by the same entity, are categorized in stage 2. This classification often depends on the point in time on which these financial assets were contracted. Practice showed that this concept is also hard to comprehend by different stakeholders. AFRAC also observed, that in practice there is ambiguity in application, as in certain cases, SICR is based (or expected to be based) on the deteriorated credit risk of the counterparty and not on the SICR of the individual instrument. However, the disclosure of the stage allocation should be clear and understandable for all users of financial statements. Therefore, AFRAC believes that the concept of SICR should be reconsidered in this regard and the complexity regarding this topic should be reduced.

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?

In our view the expenses, due to the intricacy involved, have clearly surpassed initial expectations, especially for the financial services and banking industries. The magnitude of the impact was particularly unexpected in relation to the introduction of post-model adjustments that have become necessary during the pandemic and as a result of recent macro-economic developments, simply because models (and the data developed thereby) could not adequately predict ECL under these severely changed circumstances. Data that was previously unavailable may become accessible for an extended period, rendering the actuality considerably more intricate. Consequently, the fundamental question of weighing the costs and benefits remains. We observe a prevailing notion that the substantial effort necessary for preparing the required information results in only marginal added value. Therefore, AFRAC believes that the complexity of the general approach should be reduced, as the cost of application is higher than expected.

IFRS 9 mandates entities to recognize ECL for all financial assets held at amortized cost, which also include most intra-group loans from the lender's perspective. However, IFRS standards do not specifically address issues regarding separate financial statements, apart from a brief reference in IAS 27 Separate Financial Statements. AFRAC has noted that - in practice - there are significant challenges in calculating ECL on intra-group loans. Consequently, evaluating the borrower's ability to repay the loan (based merely on contractual terms) often does not accurately reflect the controlling entity's intentions or the expected cash flows from the lender's perspective. AFRAC, therefore, recommends that IASB should consider implementing simplified rules for intra-group loans.

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?

AFRAC believes that the current principle-based approach, as opposed to prescriptive rules, is beneficial for assessing significant increases in credit risk (SICR). This approach aids to achieve the IASB's goal of recognizing lifetime ECL, if there has been a SICR since the initial recognition. At this point, AFRAC is not aware of any critical issues concerning the evaluation of SICR.

However, AFRAC would like to mention again the issue raised in the answer to question 2 a) ("same instrument with same counterparty recognised at different point in time ending up in different stages"), as it is also related to the assessment of SICR.

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

Collective assessment of significant increases in credit risk: bottom-up vs. top-down approach:

The introduction of a collective assessment for financial assets addressed the concerns that banks may have a very large number of small exposures managed on an aggregated basis. The monitoring report "IFRS 9 Implementation by EU Institutions" published by EBA in November 2021 highlighted that the use of the top-down approach in Europe is limited and that financial institutions generally prefer to use a combination of bottom-up and top-down approaches.

With regard to the two approaches concerning a collective assessment of SICR (bottom-up vs. top-down), the question arises which approach is easier to apply. AFRAC considers that the top-down approach should be maintained by the IASB, as this assessment reflects changes in the credit quality not yet detected at an individual level. However, the IASB may consider to provide more real-life examples to increase the application of the collective assessment of SICR. Such examples would ease the difficulties concerning the assessment of SICR on a collective level, by stressing the probability of default indicators, and by indicating whether and how the two approaches (top-down and bottom-up approach) can be applied simultaneously.

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?**

Forward-looking information and scenario analyses:

AFRAC observed that the central issue regarding forward-looking information and respective scenarios lies in achieving consistencies in ECL measurement despite the diverse application of different approaches, such as the principle-based approach and the necessity for post-model adjustments due to model shortcomings.

The complexity arises when attempting to implement the requirements of the standard. It turns out to be difficult for many preparers to correctly distinguish between forward-looking information, model validation, ordinary model maintenance, and exceptional and thus not representative information. Additionally, the increased use of post-model adjustments becomes a matter of concern.

Furthermore, it is essential to provide explicit instructions on when to establish or dissolve overlays and what information should be disclosed in relation to post-model adjustments. Clear requirements of disclosures in relation to post-model adjustments, consistent table formats and specific examples should serve as guidelines. Additionally, there needs to be clarity on the duration of post-model adjustments. We are of the opinion that the application of post-model adjustments should be limited to a certain period of time (e.g., 2-3 periods), as they should remain exceptions to the standard practice. This should reduce potential bias, even if it means that ECL models need to be updated.

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?**

AFRAC observes that inquiries regarding the application of the ECL model of IFRS 9 to voluntarily forgiven cash flows from lease payments prompt questions about the extent to which the concept of credit loss under IFRS 9 can be (or must be) expanded (also see answer to question 1).

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?

The standard does not sufficiently specify the handling of and the accounting for instruments falling into the category of “purchased or originated credit impaired” (POCI). AFRAC’s constituents ask for more detailed guidance on these instruments regarding both their measurement and disclosure in financial statements.

The central question arising on the topic of purchased or originated credit-impaired (POCI) financial assets is the measurement of the initial fair value. While there seem to be no practical issues in relation to purchased portfolios, where the initial fair value can be easily derived from the purchase price paid, challenges arise concerning (self-)"originated" portfolios (as a result of substantive modifications triggering de- and recognition), as in these cases the fair value of the credit-impaired loan cannot be derived from a purchase price in a real transaction.

Subsequently, the requirement to treat any change in the initial expected credit loss as a provision led to a variety of different implementations. Some banks interpret this requirement in a way that the loan loss provision can be negative (in case of further deterioration), and positive (in case of a positive development), however, such an approach poses problems for many banks' systems. AFRAC observed, that banks generally try to avoid creating POCI whenever possible, as in many cases they cannot easily handle them in their systems without manual interventions. Some preparers question whether the resulting disclosures provide useful information. Thus, the sentiment remains, that the POCI-topic is cumbersome, complex and unclear. AFRAC’s constituents, therefore, point out that the added value of a separate handling of POCI financial assets is not self-evident.

We, therefore, suggest that the applicability of the existing requirements for POCI financial assets should be limited to banks, for which the management of these types of financial assets is a central aspect of their business model and for which the POCI concept provides useful information. For other banks (or in general) the accounting concept for self-generated POCI assets should be reconsidered in order to reduce divergence in practice.

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?**

AFRAC’s constituents pointed out that the current disclosure requirements often lead to disclosures that result in “number graveyards” and do not provide useful information. Feedback obtained revealed that the most important problem is perceived in the fact that current guidelines result in different forms of non-comparable disclosures. There is too much scope as to how to address the existing disclosure requirements, so that each entity can follow its own approach, making meaningful comparisons between disclosures virtually impossible. Also, the lack of viable disclosures and the need to improve the prioritization of topics in the standard was highlighted.

The existing set of disclosures should be reconsidered and challenged. There are a number of disclosures of limited perceived added value, such as the disclosure requirements of IFRS 7.35J in relation to modified financial assets.

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?

It is generally perceived and widely acknowledged that a proper and serious audit of ECL measurement and also ECL disclosures (especially in the banking industry) is time-consuming and highly challenging and requires staff with highly specialised skills (in mathematics and statistics). The complexity lies particularly in auditing models and their validation, especially when the audit is carried out off-site. The considerable effort involved in recalculating these models and concerns regarding the ways to audit validation result in further challenges.

AFRAC constituents reported that the costs are quite significant and clearly surpass initial expectations. The constant changes in the models required by the ever-changing macro-economic environment lead to varying levels of effort required.

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?

Climate-related risks are a significant concern, especially concerning forward-looking information and scenarios that may impact business models. Banks report these risks differently, some through scoring, others through overlays or collateral measurement.

Regarding point 10b), there is a call for clearer guidance on how climate risks should be incorporated in ECL measurement and how they should be disclosed. This guidance would be perceived as beneficial.