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Andreas Barckow
Chairman
Internal Accounting Standards Board
Columbus Building, 7 Westferry Circus
Canary Wharf
London E14 4HD
United Kingdom

4 October 2023

Subject: IASB Request for Information – Post-implementation Review of IFRS 9 *Financial Instruments* – Impairment

Dear Mr Barckow,

The European Banking Authority (EBA) welcomes the opportunity to comment on the IASB's Request for Information (RfI) as regards the IFRS 9 post-implementation review (PiR) on impairment requirements. The EBA has a strong interest in promoting sound and high-quality accounting and disclosure standards for the banking and financial industry, as well as transparent and comparable financial statements that would strengthen market discipline.

The EBA strongly supports the IASB's efforts to develop clear and harmonised principles and believes that the current post-implementation review is of the utmost importance to continue developing high-quality international accounting standards.

The EBA comment letter is focused on aspects that could have an impact in prudential terms.

The EBA believes that IFRS 9 reached the main objective of providing users of financial statements with more useful information about an entity's expected credit losses on its financial assets and on its commitments to extend credit and to facilitate users' assessment of the amount, timing and uncertainty of future cash flows. Yet, while the improvements achieved in comparison to the previous standard on financial instruments are evident, the application of the standard resulted in a wide diversity of practices, which may impair the comparability of financial reporting amongst entities. The EBA also believes that recent years have made it harder to have a final judgement on the standard since not many defaults were experienced due to, in particular, government support measures. However, there are a few practical aspects that could benefit from further consideration from a standard-setting perspective.

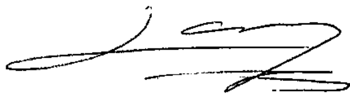
This being said, the EBA's views on targeted aspects, as raised in this PiR, are expressed in detail in the Annex to this letter. Given its special relevance from a regulatory perspective due to the link between

the level of provisioning and prudential ratios, the EBA stands ready to contributing further to future holistic debates on the impairment requirements of IFRS 9

The EBA also uses this opportunity to share some detailed information on the observations obtained as part of our benchmarking activities[1] as regards the practices implemented by the EU institutions to the extent that this information is deemed useful in the context of the current review. The EBA continues monitoring and promoting the consistent application of IFRS 9 in the EU with an ongoing exercise[2].

If you have any questions regarding our comments, please do not hesitate to contact us.

Yours sincerely



Jose Manuel Campa
On behalf of the EBA Board of Supervisors

CC: Ms Linda Mezon-Hutter, Vice-Chair of the International Accounting Standards Board (IASB)

[1] IFRS 9 Monitoring Report - 2021 (europa.eu)

[2] The next IFRS 9 monitoring report containing all the observations obtained as part of a deeper analysis of the implementation of IFRS 9 is expected to be published by Q4 2023.

Annex I: Detailed comments on the IASB's Request for Information: Post-implementation Review of IFRS 9 *Financial Instruments* – Impairment

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?

1. In overall terms, the EBA believes that the principles defined for the assessment of significant increases in credit risk ("SICR") can be applied consistently. However, the EBA has observed that, in practice, high diversity exists in the way that banks interpret the requirements for determining significant increases in credit risk.

   Approaches used for determining significant increases in credit risk

2. When making the assessment of significant increase in credit risk, entities are required to *"compare the risk of a default occurring on the financial instrument at the reporting date with the risk of a default occurring on the financial instrument as at the date of initial recognition"* (IFRS 9 5.5.9). When developing the impairment requirements, the IASB stressed the intention not to prescribe a specific method to be followed as the approaches to assess whether the credit risk has increased significantly would depend on the level of sophistication of entities and the different available data (IFRS 9 BCE5.156). While it is acknowledged that this approach taken by the IASB aligns with the principle-based nature of the IFRS 9 Standard, the EBA has observed that this has given rise to different approaches taken by banks in practice that are, not always, in line with the impairment principles as envisaged by IFRS 9. Moreover, this diversity does not seem to be justified by differences in entities' credit risk management practices.

3. These SICR assessment approaches include, among others, the following:

- Absolute thresholds: the EBA has observed that some banks use a combination of absolute and relative thresholds[3] as criteria to assess SICR. This would imply that, in those cases, both thresholds need to be reached cumulatively in order to trigger the measurement of lifetime expected credit losses; only reaching the relative threshold would not trigger SICR assessment. In this regard, the EBA believes that IFRS 9 is clear in the fact that thresholds defined in absolute terms (either as an absolute level of credit risk or an absolute credit risk increase) are generally not in line with the

[3] The term "threshold" is intended here as a certain level of probability of default or a certain rating (in an absolute or relative basis) that triggers transfer to the measurement of lifetime ECL.

impairment requirements of IFRS 9[4]. The assessment of the significance of the change in the risk of a default occurring depends on a relative assessment that considers the credit risk at initial recognition and the time to maturity (IFRS 9 B5.5.11, BC5.173)[5]. An absolute increase in the risk of default could only be suitable to determine the significance in certain specific cases such as when all instruments to which an absolute trigger is applied share the same initial risk or when after the absolute increase the instruments still benefit from the low credit risk exemption. The use of absolute thresholds for determining SICR, even in combination with other relative thresholds cumulatively, could hamper the comparability of the requirements for financial instruments with different maturities and different initial credit risks[6] and could result in delayed recognition of lifetime expected credit losses for instruments that have experienced, on a relative scale, a significant increase in credit risk. Therefore, the EBA would see merit in clarifying that the use of such approach, even in those cases of a combination with relative thresholds with both criteria that need to be reached for attaining a SICR, is not in line with the impairment requirements of IFRS 9.

- SICR thresholds determined on a "quantile approach"[7]: as part of its monitoring activities, the EBA has observed[8] that some banks make use of thresholds that are determined on the basis of chosen quantiles of distributions that are derived from historical data of changes in credit risk. In this regard, it is noted that for a selected quantile of the distribution this approach mechanically leads to higher relative thresholds for those portfolios with higher volatility in credit risk than for less volatile portfolios. In addition, this approach may level out, over time, the proportion of instruments subject to lifetime ECL around a desirable percentile across economically different portfolios.

  In accordance with IFRS 9 BC5.173, the assessment of significance *"would depend on the credit risk at initial recognition and the time to maturity. This is because it would be consistent with the*

[4]In accordance with IFRS 9.B5.5.9, when determining the significance of an increase in the credit risk, "a given change, in absolute terms […] will be more significant for a financial instrument with a lower initial risk […] compared to a financial instrument with a higher initial risk […]".

[5] According to IFRS 9 B5.5.11 "Because of the relationship between the expected life and the risk of a default occurring, the change in credit risk cannot be assessed simply by comparing the change in credit risk cannot be assessed simply by comparing the change in the absolute risk of a default over time".

[6] In accordance with IFRS 9 BC5.17 'a given increase (in absolute terms) in the risk of a default occurring reflects a greater increase in credit risk the shorter the term of the financial instrument and the lower its initial credit risk'.

[7] For the purpose of this comment letter, the term "quantile approach" is intended as any approach based on a comparison between the PD at the reporting date and the PD of an x% quantile of the forward probability distribution of changes in PD, based on the risk assessment at initial recognition. An example of a PD quantile approach is provided below:

– the institution collects historical data on relative changes in PDs (either lifetime PDs or 12-month PDs) at instrument level. Those historical data constitute a distribution based on which it could be assessed how frequently a certain relative change in the risk of default since origination was observed.

– the institution statistically identifies a X% quantile of this distribution. The relative change in PD corresponding to the X% quantile of the distribution represents the quantitative threshold for SICR.

[8] See page 33 of the EBA IFRS 9 Monitoring Report

structure of credit risk and therefore with the pricing of the financial instrument […] an entity should consider the term structure and the initial credit risk in assessing whether it should recognise lifetime expected credit losses". In the EBA's view, a SICR threshold based on a quantile approach could hamper the comparability of the requirements for financial instruments with different maturities and different credit risk. The use of this approach could result in portfolios that have a higher volatility in credit risk benefiting from more lenient SICR thresholds that are not dependent only on the credit risk at initial recognition and the time to maturity of the financial instruments included therein. Hence, the EBA would see merits in the clarification of whether quantile approaches are in line with the IASB's main objectives of the impairment model of IFRS 9 and, in particular, with the concept of "significance" as envisaged in the Standard. In this regard, the EBA is of the view that such clarification should be accompanied by specific guidance, including caveats and demonstrations that, indeed, the assessment of SICR is not delayed.

In addition, it could be further specified that when assessing significant increases in credit risk, entities are expected to apply this concept consistently across portfolios and/or financial instruments and over time (i.e., the concept of what should be interpreted as significant should not be relaxed in periods of a deteriorated macroeconomic outlook and higher volatility in credit risk).

Collective assessment for determining significant increases in credit risk

4. The objective of IFRS 9 impairment requirements is to timely capture *"lifetime expected credit losses for all financial instruments for which there have been significant increases in credit risk since initial recognition –* ***whether*** *assessed on an individual* ***or*** *collective basis*[9] *– considering all reasonable and supportable information, including that which is forward-looking"* (IFRS 9 5.5.4).

5. The monitoring activities conducted by the EBA on the implementation of IFRS 9 have shown banks' uncertainties regarding how and, especially, when collective assessments should be performed to determine SICR. This has resulted in diversity in practice[10] which includes, among others, circumstances in which banks have performed **both** individual and collective assessment approaches – when information captured individually was not considered sufficient – and others in which banks have performed either individual **or** collective assessments – depending on the assessment of whether borrower-specific information was available without undue cost or effort.

6. Collective assessment approaches are essential to identify significant increases in credit risk in a timely manner. In the EBA's view, collective SICR assessments are expected to complement individual SICR assessments, in particular in those cases of uncertainties in the evolution of the current macroeconomic outlook and emerging novel risks, but also in those circumstances where

[9] Emphasis added.

[10] See page 27 of the EBA IFRS 9 Monitoring Report

information, including that which is forward-looking, is not available at individual level without undue cost or effort.

7. In this regard, it is noted that the wording employed by the Standard might cast different expectations on when and how collective assessments should be performed[11]. For this reason, the EBA sees merits in providing clearer guidance on the overall application of collective assessments by, for instance, clarifying the following:

- The objective of the impairment requirements is to reflect the economics of lending to provide users of financial statements with relevant information about the performance of financial instruments [12] . Therefore, the assessment of significant increases in credit risk should be performed at individual financial instrument as the default level.

- For those cases in which not all reasonable and supportable information, including that which is forward-looking, is available without undue cost or effort on an individual basis, entities shall complement the assessment on individual financial instrument level with a collective assessment for those factors or indicators that are not identifiable at individual level.

- The collective assessment, for those factors or indicators that cannot be identified on an individual financial instrument level, shall be performed on portfolios that are segmented on the basis of common borrower-specific information and the effect of forward-looking information that affect the risk of a default occurring could be considered for each segment. Therefore, entities would use the change in that macroeconomic indicator (i.e., forward-looking information) to determine that the credit risk of one or more segments of financial instruments in the portfolio has increased significantly[13] (i.e., IFRS 9 IE38 or "bottom-up approach").

- For those portfolios for which segmentation on the basis of common borrower-specific information is not possible, entities shall use reasonable and supportable information to determine that the credit risk of a homogeneous portion of a portfolio should be considered to have increased significantly in order to meet the objective of recognising all significant increases in credit risk (i.e., IFRS 9 IE39 or "top-down approach").In this regard, other examples could be added leveraging on practices observed during the pandemic.

8. With particular reference to the Illustrative Example on collective assessment (i.e., IE38 and IE39), the EBA has observed that a limited use of the top-down approach[14] (as described in IFRS 9 IE39) is made, in general, by banks. While it is noted that IE39 illustrates the way in which such approach

[11] Please see Annex for specific examples.

[12] IFRS 9 BC5.167

[13] IFRS 9 BC5.140

[14] See page 27 of the EBA IFRS 9 Monitoring Report

should be performed, the calculation of the percentage of the portfolio for which credit risk is deemed to have increased significantly can be difficult to estimate, in practice, by banks. The EBA acknowledges the challenge that providing specific guidance (e.g., examples on how this percentage could be calculated) might entail but considers that complementing the example with some illustrations of how the share of the portfolio to be moved to stage 2 can be derived could increase the use of "top-down" collective assessments.

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?

Post-model adjustments or management overlays

9. Following the monitoring activities conducted by EBA on the implementation of IFRS 9, it has been observed that post-model adjustments or management overlays ('overlays') have become increasingly common amongst European banks. The EBA acknowledges that these overlays can be a valid tool to temporarily adjust ECL estimates, in order to reflect, in a timely manner, relevant emerging risk factors not captured by the ECL models. However, different practices have been observed, for instance, regarding the risk factors considered, calibration methodologies, levels of application and effects on SICR assessment. Overlays also represent an additional source of variability, in particular, with reference to their diverse impact on the final ECL figures.

10. From a standard-setting perspective, it should be further explored whether additional guidance can be provided on the situations where their use may be relevant and the possible ways in which they should be applied. For instance, while certain banks have applied overlays in relation to well-defined risk factors, in some cases by also identifying a related group of exposures based on shared credit risk characteristics (e.g., vulnerable sectors), others have instead used overlays for broadly defined risks. Likewise, a range of methodological approaches have been used to calibrate their effects, ranging from pure judgemental approaches to stress tests, sensitivity analysis and/or sectorial assessments, which may lead to further diversity and reinforces the need for banks to follow a more structured approach framed under strict governance and internal controls.

11. The EBA has also observed that overlays were applied either at the level of the final ECL output, or at risk-parameter level (i.e., PD, LGD, internal rating). The former approach is perceived as lacking granularity on the nature of the model adjustment and, in the EBA's view, should be used only in cases where it requires a disproportionate effort to manually adjust the models in a more precise manner. Moreover, the application of overlays to an exposure (or group of exposures) may suggest

that there are risk factors not well identified by the models, and the EBA is also of the view that these additional sources of risk should be incorporated for staging assessment as well. For this purpose, the use of overlays at the level of risk parameters may be better suited to reflect, on an individual basis, directly on the risk of default, the additional risk factors identified. On the other hand, when the factors driving the ECL overlays are linked to the risk of default, such as when there is uncertainty on the impacts of high inflation in the debtors' payment capacity, their effects shall be also taken into account in the assessment of significant increases in credit risk. In this way, where ECL overlays are used, and the driving factors have effects on the risk of default, complementary measures, such as collective SICR assessments, should be applied to ensure that the requirement of IFRS 9 5.5.4 is met.

12. To summarise, the EBA would see merits in providing additional guidance in the Standard on the application of overlays in a similar manner as currently exists for collective SICR assessments. For instance, it could be highlighted that overlays may be needed in circumstances where implemented (statistical) models are unable to reflect timely in ECL estimates all reasonable and supportable information that is available without undue cost or effort. For this purpose, entities can group financial instruments on the basis of shared credit risk characteristics with the objective to facilitate the definition of the scope and measurement of the model adjustment.

13. To further clarify the use of overlays, illustrative examples could also be provided regarding the situations and ways in which it could be applied as well as, where deemed relevant, the possible links with the SICR assessment. Moreover, in order to limit the application of pure judgmental approaches, the EBA would also see merits in highlighting that the use of overlays should be accompanied by a sound methodological approach[15] and supported by appropriate governance and processes[16].

ESG including climate risk

14. Another relevant topic worth mentioning concerns the incorporation of ESG, including sustainability-related risks, in ECL estimates and in the SICR assessment. In the context of its monitoring activities, the EBA observed that only a few entities had put in place specific model updates and/or overlays for climate-related risks, although the issue is increasingly assessed by European banks. The EBA considers that this topic deserves particular attention and, following our joint monitoring with supervisory authorities, going forward, further discussion and interaction with IASB is deemed necessary.

[15] IFRS 9 paragraph IE39 of Illustrative Example 5 illustrates the use of such a methodological approach to determine the portion of financial assets for which credit risk is deemed to have increased significantly.

[16] Paragraph 56 of the EBA Guidelines on ECL (EBA/GL/2017/06) highlights that "in order to avoid the creation of potential for bias, temporary adjustments should be directionally consistent with forward-looking forecasts, supported by appropriate documentation, and subject to appropriate governance processes".

15. In this context, the EBA welcomes the IASB's project on *Climate-related Risks in the Financial Statements* which may help to identify any gaps in the Standards that could hinder the adequate incorporation of climate risks in financial statements.

Forward looking scenarios

16. In overall terms, the EBA believes that the core objectives regarding the incorporation of forward-looking information ("FLI") into the ECL estimations are clearly stated in the IFRS 9 requirements. Moreover, it is noted that the envisaged consideration of forward-looking information in the impairment requirements has generally allowed to recognise – in a timely manner and without waiting for the occurrence of a specific loss event as required by IAS 39 – the expected credit losses on financial instruments based on a broader set of information and expectations of the future economic conditions.

17. IFRS 9 5.5.17 sets out how entities need to measure ECLs which include, among others, the need to reflect a probability-weighted amount that is determined by evaluating a range of possible outcomes and the need to duly consider all 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. Nonetheless, in the EBA's view, the Standard lacks specific guidance on the way in which these objectives are to be achieved (e.g., which set of information and type of alternative scenarios should be considered; or which techniques, models or practices need to be followed to incorporate FLI into the expected credit loss measurement). This absence of specific guidance has, according to the IFRS 9 monitoring carried out by the EBA, left preparers with ample room for judgement, resulting in different impacts stemming from FLI incorporation and, thus, less comparable ECL results.

18. While it has been observed that banks generally adopt multi-scenario approaches for estimating ECLs, diversity has been noted, for instance, with regards to the number and severity of the scenarios considered, the list of macroeconomic variables used to incorporate FLI at risk parameter level, the length of the macroeconomic projections, as well as the weights assigned to the probability of the envisaged scenarios.

19. In this context, the EBA has noted certain approaches which appear inconsistent with IFRS 9 requirements. Namely: (i) the usage of one single scenario without further adjustments for non-linearity, (ii) the non-consideration of FLI elements in the IFRS 9 LGD, (iii) the use of excessively long forecasting period, and (iv) the extended time horizon to revert on long-term macroeconomic conditions when lifetime risk parameters are estimated.

20. With reference to the use of one single forward-looking scenario without further adjustments to reflect non-linearity, it is noted that at the December 2015 ITG meeting a question was raised as

to whether the use of multiple scenarios referred to in the standard relates only to what might happen to particular assets given a single forward-looking scenario, or whether the application of the Standard requires entities to use multiple forward-looking economic scenarios and, if so, how. At that time, it was clarified that the measurement of ECLs is required to reflect an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes. Consequently, when there is a non-linear relationship between the different forward-looking scenarios and their associated credit losses, using a single forward-looking economic scenario would not meet the objectives of IFRS 9 impairment requirements. Given the importance of incorporating all relevant forward-looking information in the measurement of ECLs, reference in the Standard in this regard should be warranted to ensure that while it may not be necessary to use multiple scenarios to apply the impairment requirements in IFRS 9 (i.e., when it is demonstrated that the linear relationship between the different forward-looking scenarios and their associated credit losses exists), multiple forward-looking economic scenarios must always be considered in all other cases.

21. Moreover, it has been observed that some banks have introduced smoothening practices to their FLI approaches with the aim of achieving more "through-the-cycle" ECL figures which may not fully meet the expectations of the Standard, given the point-in-time and forward-looking nature requested by IFRS 9[17].

22. According to the data collected by EBA in its monitoring works on IFRS 9, in the last years, the impact of the incorporation of FLI among banks has been generally modest (below 10% in terms of final ECLs figures), but a relevant dispersion has been observed, with entities reporting impacts ranging from 0% to 60% on the final ECL figures. Additionally, a very limited impact (below 5% in terms of final weighted ECLs) was noted stemming from the consideration of the non-linearity into the measurement of ECLs, with final figures generally mostly driven by the assumptions underlying the baseline scenario.

23. Against these considerations, the EBA would welcome any further clarifications and additional guidance in relation to the incorporation of FLI in the measurement of ECLs. For instance, preparers of financial statements may benefit from further rationale behind the existing requirements to reflect a range of possible outcomes that determines an unbiased and probability-weighted outcome. In this regard, further clarifications could be provided (also by means of illustrative examples) on the type of alternative scenarios to be used for the ECL calculation. Additionally, it could be specified the need to ensure consistency between the different scenarios considered (in terms of severity and plausibility) and the related probability of occurrence. This would ensure the

[17] In accordance with IFRS 9 BC5.282 "through-the-cycle approaches consider a range of possible economic outcomes instead of those that are actually expected at the reporting date. This would result in a loss allowance that does **not reflect** the economic characteristics of the financial instruments at the reporting date" (emphasis added).

reflection of non-linearity between the different forward-looking economic scenarios and their associated final ECLs.

24. Additionally, and keeping in mind that, even if not explicitly prescribed by the Standard, banks make use of statistical approaches to calculate ECL, it could be stressed the need to incorporate FLI in all the different dimensions of ECL estimations, referring, in general terms, to the assessment of the risk of default and the assessment of the severity of the losses, for all the envisaged projected scenarios. This clarification would be aimed at addressing the limited consideration of FLI at LGD level and to better reflect FLI into the final ECL figures.

25. More specific guidance or illustrative examples on the type of information and length of the projections which would be considered reasonable and supportable according to the Standard would also be welcomed by the EBA. Even if the IASB has already noted in its Appendix B of IFRS 9 (IFRS 9 B.5.5.50) that: i) *"an entity is not required to incorporate forecasts of future conditions over the entire expected life of a financial instrument";* ii) *"as the forecast horizon increases, the availability of detailed information decreases"*; iii) *"the estimate of expected credit losses does not require a detailed estimate for periods that are far in the future"*, these clarifications have not prevented many preparers to anchor their ECL estimations to excessively long forecasting period. The additional clarifications should be, therefore, aimed at limiting the time horizon of the macroeconomic projections and the time to reversion to historical mean values used by many banks for estimating lifetime risk parameters and ECL estimations. This would also ensure meeting the objective of determining expected losses based on reliable/supportable information as required by IFRS 9.

26. Lastly, the point-in-time and forward-looking nature of the IFRS 9 estimates could be further stressed in the revision of the Standard to prevent the usage of practices aimed at achieving less volatile ECL estimations. In this regard, reference in the Standard should be introduced to reinforce that through-the-cycle approaches could result in a loss allowance that does not reflect the economic characteristics of the financial instruments at the reporting date as stated in IFRS 9 BC5.282.

Annex II – Specific examples on the wording used in IFRS 9 with reference to collective SICR assessments

- In accordance with IFRS 9 5.5.11, *"If reasonable and supportable forward-looking information is available without undue cost or effort, an entity cannot rely solely on past due information when determining whether credit risk has increased significantly since initial recognition. However, when information that is more forward-looking than past due status (**either** on an individual **or** a collective basis) is not available without undue cost or effort, an entity may use past due information to determine whether there have been significant increases in credit risk since initial recognition";*

- IFRS 9 B5.5.1 further specifies that *"In order to meet the objective of recognising expected credit losses for significant increases in credit risk since initial recognition, it **may** be necessary to perform the assessment of significant increases in credit risk on a collective basis […]";*

- For those cases where banks do not have reasonable and supportable information that is available without undue cost or effort on an individual basis, IFRS 9 B5.5.4 prescribes that *"lifetime expected credit losses **shall** be recognised on a collective basis";*

- In the Basis for Conclusions of IFRS 9, the IASB noted that *"in some circumstances the segmentation of portfolios based on shared credit risk characteristics **may assist** in determining significant increases in credit risk for groups of financial instruments";*

- Finally, IFRS 9 Illustrative Example 5 provides a situation in which a bank assesses the risk of default occurring by performing both an individual assessment – for the past due status information – and a collective assessment – in order to incorporate other reasonable and supportable forward-looking information that is available without undue cost or effort as required by IFRS 9 5.5.4.