ICAEW
REPRESENTATION 98/23

POST-IMPLEMENTATION REVIEW OF IFRS 9 - IMPAIRMENT

Issued 27 September 2023

ICAEW welcomes the opportunity to comment on the Post-implementation Review of IFRS 9 - Impairment published by IASB on 30 May 2023, a copy of which is available from this link.

For questions on this response please contact our Financial Services team at fsf@icaew.com quoting REP 98/23.

We welcome the opportunity to comment on the IASB's post implementation review of IFRS 9 *Financial Instruments* Impairment. The standard was a significant response to the global financial crisis of 2007/08 and a review of its effectiveness is an essential activity to ensure the standard operates as intended.

The impairment aspects of the standard appear to be working well. It is however perhaps too early to be conclusive, as they have yet to be tested by a financial crisis or severe economic downturn. We would also note that the impairment requirements of the standard were primarily drafted to deal with credit risk and impairment within the banking sector. As a result, it is a complex standard and one that consequently is difficult to understand and apply in any context outside of the banking sector.

ICAEW
Chartered Accountants' Hall Moorgate Place London EC2R 6EA UK
T +44 (0)1908 248 250 F +44 (0)20 7920 0547   icaew.com

The Institute of Chartered Accountants in England and Wales (ICAEW) incorporated by Royal Charter (RC000246)
Registered office: Chartered Accountants' Hall Moorgate Place London EC2R 6EA UK

This response of 27 September 2023 has been jointly prepared by the ICAEW Corporate Reporting Faculty and Financial Services Faculty.

Corporate Reporting Faculty: Recognised internationally as a leading authority on corporate reporting, the faculty, through its Financial Reporting and Non-Financial Reporting committees, is responsible for formulating ICAEW policy on financial and non-financial reporting issues and makes submissions to standard setters and other external bodies on behalf of ICAEW. The faculty provides an extensive range of services to its members including providing practical assistance with common corporate reporting problems.

Financial Services Faculty: As a leading centre for thought leadership on financial services, the faculty brings together different interests and is responsible for representations on behalf of ICAEW on governance, regulation, risk, auditing and reporting issues facing the financial services sector. The faculty draws on the expertise of its members involved in financial services.

ICAEW is a world-leading professional body established under a Royal Charter to serve the public interest. In pursuit of its vision of a world of sustainable economies, ICAEW works with governments, regulators and businesses and it leads, connects, supports and regulates more than 166,000 chartered accountant members in over 146 countries. ICAEW members work in all types of private and public organisations, including public practice firms, and are trained to provide clarity and rigour and apply the highest professional, technical and ethical standards.

© ICAEW 2023
All rights reserved.
This document may be reproduced without specific permission, in whole or part, free of charge and in any format or medium, subject to the conditions that:
• it is appropriately attributed, replicated accurately and is not used in a misleading context;
• the source of the extract or document is acknowledged and the title and ICAEW reference number are quoted.
Where third-party copyright material has been identified application for permission must be made to the copyright holder.

KEY POINTS

1. We welcome the opportunity to comment on the IASB's Post-implementation Review of IFRS 9 *Financial Instruments* Impairment. Our detailed comments and recommendations can be found in our responses to the individual questions. We have not sought to answer every question in detail and have focused on those issues of most relevance to our members.

2. Throughout our response, we have made a distinction between financial and non-financial entities. For clarity when we refer to financial entities in this response, this includes banks, building societies in the UK, and other similar entities whose business model is typically extending credit and managing credit risk. Insurance entities are usually considered financial entities, but, unless explicitly referenced, are excluded from our response for the reason set out in paragraph 13. Non-financial entities refers to all other entities.

3. We do not believe that there are fundamental flaws with the impairment requirements in IFRS 9. We believe that the standard has achieved its objectives which, has led to the earlier recognition of credit losses in recent years and has also helped to improve overall credit stewardship.

4. However, we would caution that the standard has not yet been tested by a financial crisis or more severe economic recession and the significant levels of defaults that might be expected in these circumstances. Recent stress events in the UK have been unique and unprecedented, both in terms of the nature of the stresses and the availability of significant government support to mitigate the effects on economies and individual borrowers. The various government initiatives dampened the effects of the stresses, resulting in modest increases to expected credit losses (ECL) for UK banks, many of which were reversed in subsequent periods as the UK economy re-opened.

5. With the benefit of hindsight, we are not persuaded that the benefits of the impairment requirements of the standard have outweighed the costs of their implementation for non-financial entities, for whom the impairment requirements of the standard were not designed and, consequently, where the requirements are complex and often difficult to understand. For financial entities, we perhaps will not know whether the benefits of the standard have outweighed the costs of implementation until we have experienced a severe economic recession.

6. That said, we do not see any benefit to significantly changing the standard but would support simplification for non-financial entities, especially smaller corporates and SMEs (eg, greater application of the simplified approach, reduction in disclosure requirements, etc.).

7. We have also identified several areas where the disclosure requirements could be enhanced as well as areas where we think further guidance would be beneficial (please see our response to Question 9 below).

ANSWERS TO SPECIFIC QUESTIONS

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?***

Recognition of credit losses

9. We believe the standard has generally delivered more timely and accelerated recognition of credit losses compared to the incurred loss model in IAS 39 *Financial Instruments: Recognition and Measurement*. This is a natural reflection of the forward-looking nature of the standard and this has been demonstrated by the stressed conditions under which the standard has been operating in recent years (eg, COVID-19, inflation and rising interest rates, cost of living pressures, war in Ukraine).

10. We note that financial entities made considerable provisions for ECLs during the early onset of COVID-19, but that a large proportion of these provisions were subsequently released. We do not believe this indicates a failure of the standard, although in hindsight it led to an over-estimation of credit losses. All entities, including financial entities, were operating in a period of significant stress. The initial high provisions reflected the best estimate of the expected loss, taking into account the significant inherent uncertainty about future conditions at that time. It is a consequence of a forward looking standard that future expectations change as circumstances change and more and/or better information becomes available.

11. We would caution that the standard has yet to be tested by a financial crisis or a more severe economic recession and the significant levels of defaults that might be expected in these circumstances. Recent events have been somewhat unique, and without any recent historical precedent. While the events have placed significant stress on economies and borrowers and consequently increased credit risk, significant government support measures have mitigated (or delayed) the adverse effects of the stresses experienced by borrowers. Until a financial crisis or more severe economic recession is experienced, it is not possible to provide a definitive view on whether the impairment requirements of the standard have ensured that there will be more timely recognition of credit losses.

12. We agree that the standard has removed the complexity caused by having multiple impairment models for financial instruments.

13. Finally, we note that many insurance undertakings applying IFRS 17 *Insurance Contracts* have not yet fully implemented IFRS 9. The interaction between IFRS 9 and IFRS 17 will be an important consideration when the IASB undertakes its post implementation review of IFRS 17.

© ICAEW 2023

Useful information

14. We believe the standard has provided useful information about the effect of credit risk on the amount timing and uncertainty of future cash flows for financial entities. This seems appropriate as the management of credit risk is fundamental to these entities.

15. However, we are not convinced that is always the case for non-financial entities, mainly because their significant financial instruments (typically trade receivables) are not arising from the business of extending credit and managing credit risk but are incidental to their main operating activities.

16. Please also see our comments under Question 9.

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?

17. Overall, we do not believe that there are fundamental questions about the general approach to recognising ECL.

18. However, as in question 1 we would draw the distinction between financial entities and non-financial entities. The staging in the general approach (as illustrated on page 8 of the Request for Information) generally works for financial entities as it helps signal the changes in credit risk exposure of the assets and avoids over providing (eg, against new originated assets for which credit risk has not changed significantly since origination). The approach is typically not adopted by non-financial entities as, for the reasons in paragraph 21, they seek to take advantage of the simplified approach where available.

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?

19. The assessment of whether there has been a significant increase in credit risk (SICR) is primarily a consideration for financial entities whose business model is extending credit (ie, lending).

20. We do not believe there are any fundamental questions about the assessment of SICR. In general, we also believe that the standard’s use of staging has worked well to signal to the market changes in an entity’s exposure to credit risk.

21. We understand that non-financial entities typically look to apply the simplified approach in paragraphs 5.5.15 - 16 of IFRS 9 where possible. We believe this is due to a combination of

the nature of the main financial instruments that these entities have (ie, trade receivables) and the complexity and costs associated with implementing the SICR approach.

22. We do however have some observations below about the application of SICR that we hope are helpful.

Consistency of application

23. We observe there is diversity in practice in terms of how entities apply SICR and determine the relevant stage for a financial instrument. This is somewhat inevitable given the range of entities that apply the standard and the principles-based approach of the standard where, for example, firms are required to make use of their own internal credit risk management processes. By necessity, the range of entities means that a principles-based approach is the logical and potentially only appropriate option for the standard.

24. Nevertheless, the IASB could give further thought to whether there are areas where additional more granular disclosures could be made, to drive a greater level of comparability. For example, IFRS 7 *Financial Instruments: Disclosures* paragraph 35G is focused on disclosing the bases upon which the SICR assessment is made, whereas it could also require additional disclosure of the actual thresholds used to measure SICR and determine staging.

25. We recognise that the lack of consistency and hence comparability is a concern of stakeholders, particularly within the banking sector. The UK banking regulator for example, is seeking to drive greater consistency of methodologies through its engagement with the major UK banks. Some particular areas of inconsistency that we have identified are set out below.

Definitions

26. ICAEW do not believe that ‘significant’ is a term that is properly defined and explained in the standard and, as such, that is likely to have contributed to inconsistent practice. There is also a view that the application of significance is not always assessed by reference to the actual credit stewardship role undertaken by banks.

27. Recommendation: ICAEW encourages the IASB to give consideration to the application of ‘significant’ in practice by developing greater understanding of how entities and users judge what is significant or not. UK banks, for example, appear to be moving away from qualitative measures and are increasingly focusing on quantitative measures, and there is a perception that users are looking for a more numerical-based input to assessing significance.

Relative v absolute measure of credit risk

28. SICR is a relative measure of the increase in credit risk, as opposed to an absolute measure. Our understanding is that many risk functions do not think about credit risk in this way and as such, it makes implementation and application challenging. It can also lead to inconsistency as a relative measure is not always then applied in practice.

29. Recommendation: ICAEW believes that the inconsistency described above is also potentially caused by imprecision in the standard which could be clarified by a careful review of the wording used in the standard and/or accompanying guidance on applying relative measures.

© ICAEW 2023

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?***

30. We do not believe there to be any fundamental questions about the requirements for measuring expected credit losses.

31. The Request for Information invites observations on the three spotlighted areas: forward-looking scenarios, post-model adjustments or management overlays and off-balance-sheet exposures. Our observations on forward-looking scenarios and post-model adjustments (PMA) are set out below. The comments do not represent fatal flaws but rather areas for the IASB to consider as part of the post-implementation review. We have no significant observations on off-balance-sheet exposures.

Forward looking scenarios

32. This is a complex aspect of the standard, with a range of different practices that has led to areas of inconsistent practice. Disclosures are often confusing as there is little similarity between scenarios (other than the base case) used by different entities to calculate their probability-weighted ECL.

33. In practice we observe a range of approaches to determining a probability-weighted ECL – for example the use of Monte Carlo simulations or discrete economic scenarios. There is also inconsistency between financial entities that use discrete economic scenarios: some might use three, others four and so on. These differences are in part due to the different approaches to credit risk management and differences in underlying credit portfolios. This is also an inherently complex area (for example economic data changes rapidly while relationships between economic indicators are not static) which inevitably leads to different approaches. In this respect the standard cannot be too prescriptive as it needs to accommodate these variations.

34. Some of the current approaches that entities have adopted (for example the use of multiple economic scenarios, that loans cannot be split across stages) are a result of discussions of the Transition Resource Group for Impairment of Financial Instruments (ITG). These discussions dealt with core matters where the standard was silent or unclear.

35. There is also a view that the use of multiple scenarios is in practice somewhat seeking to incorporate and explore the effects of significant downside scenarios in the probability weighted average calculation. We have seen the situation where paragraph 5.5.18 led to an entity deriving a loss scenario notwithstanding the credit risk was so low that the entity's own risk management processes would not have considered that scenario. We believe however the original aim of the standard was to explore non-linearity in the portfolios (and as discussed at the ITG's December 2015 meeting).

36. We understand that analysts find the base case disclosures helpful but they struggle to understand the disclosures of other scenarios, and in particular the downside scenarios as there is no consistency between entities.

37. <u>Recommendation</u>: ICAEW believes it would be appropriate for the ITG comments to be incorporated into the standard. These comments, which were to fill the perceived gaps in the standard, would provide a proper footing for the approaches being adopted in practice.

38. Recommendation: ICAEW suggests additional requirements be added to the standard for disclosures of the sensitivities of the significant judgements in the base case. This would more closely align the standards with similar requirements in IFRS 13 *Fair Value Measurement,* IFRS 17 *Insurance Contracts* and IAS 19 *Employee Benefits*, for example.

Post model adjustments

39. Recent ECL calculations for financial entities have incorporated significant PMAs. This reflects the unique and unprecedented nature of the recent stress events (see question 1 for more detail).

40. We expect that there will always be a case for PMAs for all entities that undertake an expected credit loss calculation. The extent to which they will be used will be determined by the extent to which future expectations can be modelled using past data, whether sufficient data exists to model losses, or whether there is a sufficient cost benefit trade off to justify modelled over more simplified approaches.

41. There is a perception that PMAs are generally working well in the UK and do not reduce the usefulness of disclosures, as we understand there has been little critical investor feedback of the disclosures that have been made. This is attributed to the UK's disclosure regime, which is relatively well developed and advanced, and goes beyond the requirements of the standards. This is in part due to the Taskforce on Disclosures about Expected Credit Losses (DECL)[1], though certain disclosures proceeded DECL.

42. One potential area of weakness is that it is not always clear within the disclosures how PMAs have been applied, particularly when considering sensitivity analysis and how the PMAs might affect the different scenarios. There perhaps needs to be wider consideration in terms of how PMAs are applied outside of the base case scenario in a way that's understandable and not overly onerous.

43. Recommendation: ICAEW suggests there is some explicit wording in the standard that indicates the disclosure requirements covering key assumptions and inputs also apply to PMAs. While the standard is not prescriptive, it should be made clear that PMAs are not a special case. They are just another form of judgement that is made in the ECL calculation, and as such there should be adequate disclosure to understand their effect and impact on the ECL calculation.

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?

44. We do not believe there are fundamental questions about the simplified approach.

45. We believe there is a need for the simplified approach as there are financial instruments, such as trade receivables, that are not suited to the conceptual rationale of the general

[1] News I Financial Reporting Council (frc.org.uk)

approach. In addition, due to its complexity, the costs of implementing the general approach would likely outweigh any benefit (eg, for short-dated items).

46. Recommendation: We think there is merit to exploring the possibility of extending the simplified approach to more instruments (possibly inter-company or director's loans for example), or to business models where credit risk is incidental to their main operating activities – as would currently be the case with trade receivables in non-financial sectors.

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?

47. We are not aware of any significant or widespread concerns in relation to the requirements for purchased or originated credit-impaired financial assets.

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?

48. In answering this question, we have focused on the examples highlighted in the narrative to question 7 in the Request for Information.

Modification of financial assets

49. In general, we agree with the concerns expressed in the post-implementation review Request for Information. Modification of financial assets is a complex area and one where we think the standard would benefit from further guidance, especially in relation to the order in which a modification or write-off should be applied and the related disclosures.

50. In a reasonable number of cases the terms of an asset are modified because the borrower is able to repay a part but not all of the asset. In this circumstance, it might be appropriate to apply a write-off in respect of the part that cannot be repaid, and then apply the modification requirements. This might mean a less than substantial modification and the asset remaining in the pre-modified stage.

51. One matter that we think might be a particular cause of confusion is the IFRS Interpretations Committee (IFRS IC) decision on *Lessor Forgiveness of Lease Payments (IFRS 9 Financial Instruments and IFRS 16 Leases).* This could suggest that where there is a non-credit event that leads to a change in the cash flows, any shortfall is to be treated as a credit impairment loss rather than a valuation loss. While it has not been an issue in the UK currently, examples have been seen elsewhere in Europe where governments have unilaterally imposed changes (eg, interest caps) and the IFRS IC's view would suggest any shortfalls are anticipated via a credit impairment loss prior to the modification being legally enacted.

52. Recommendation: We would suggest the IASB's broader project on asset modification considers the IFRS IC issue and whether any changes are required to deal with the concern identified.

Write-off of financial assets

53. We agree this can be an area of inconsistency, as noted in the example in the question 7 narrative. This is particularly the case between different jurisdictions where market practice for some has evolved to write-off the assets early, while for others longer periods have become the norm – many years in some cases. Nevertheless, even within a single jurisdiction, different approaches may be adopted by entities. Some entities can be relatively activist and write-off early, others may be more passive and hold a position for longer. There may also be differences between financial instruments where more common practices may have evolved for certain instruments, whereas for others (eg, wholesale exposures) practice is more variable. The effect is that impairment coverage ratios or similar measures could look quite different between entities thereby reducing comparability.

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?

54. We recognise there is a challenge when drafting a standard to know how extensive and detailed it needs to be to deal with the conceptual and practical issues that may arise upon implementation. There will often be fact patterns that subsequently emerge for which further guidance is necessary, and which may have been difficult to identify during the developmental stage of the standard.

55. A case in point is the use of multiple economic scenarios (MES), the development of which entailed a considerable amount of time and effort to demonstrate non-linearity. This effort was not envisaged at the time the standard was issued, whose guidance was too broad and lacked practical application. For example, prior to the ITG discussions it was not envisaged there may be a need to prepare multiple economic scenarios beyond the two implied by paragraph 5.5.18. The issue was only discovered during implementation.

56. The standard is relatively complex and, we believe, difficult to understand for many entities outside of financial services. As a result, we are conscious that many non-financial entities found implementation particularly challenging which lead to costs (for example, to develop provision matrices), which when set against the simplified nature of their portfolios, may have outweighed any benefit.

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?

57. ICAEW notes that the level of disclosure has increased considerably as a result of the standard, and that there may be some merit in the IASB reflecting whether it is comfortable with the outcome. We do not believe, however, that there are fundamental questions about

the disclosure requirements in IFRS 7 for credit risk. The position varies across different sectors and entities but, generally, we feel that standard has helped improve the understanding of credit risk.

58. Nevertheless, we believe there are certain changes that could be made that would significantly enhance the understanding of an entity's credit risk and promote greater consistency between entities. For example, there are a few useful disclosures that UK banks make which are not required by the standards. These disclosures were decided upon as best practice for large UK banks and were incorporated in guidance published by the Taskforce on Disclosures about Expected Credit Losses (DECL). We do not propose that the standard should adopt the disclosures required by the DECL guidance, because that was developed very much for large complex banks, and they are very much ideal best practice. We believe however that there may be benefit to certain of the disclosures being included in the standard as noted in the recommendations below.

59. Recommendation: ICAEW suggests that the standard would benefit from requiring a standardised disclosure of a table outlining the movement of gross exposures and ECL (sometimes referred to as a roll-forward table)[2]. Many jurisdictions do not include this table, and its absence undermines the ability to undertake global benchmarking. We also believe it is well received by investors. We would also suggest the IASB consider including more specific disclosure requirements about judgmental adjustments made by an entity, as this was an area of focus when developing the DECL guidance as not explicitly covered by IFRS 7.

60. Recommendation: as highlighted under question 4, ICAEW also suggests there is an additional requirement added to IFRS 7 to provide information about sensitivities of the expected credit loss calculation given that this is a critical judgement area. Section G.4 of the DECL guidance illustrates a potential sensitivity that could be adopted (ie that each scenario is also given a 100% weighting).

61. Recommendation: ICAEW also thinks that the IASB should give some thought to identifying best practice examples, and publishing those on its website as an alternative means of driving improvements and consistency. This would be particularly helpful for non-financial entities that have less experience in this area.

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?

Further matters to examine: sustainability

62. Financial instruments are increasingly incorporating features linked to sustainability, including climate change. These features may not be linked to the credit worthiness of the individual borrower, but they may lead to changes in the cash flows the holder of the financial

[2] For example see D.1 and E.2 of DECL.

© ICAEW 2023

instrument may expect to receive. There may be a need for further application guidance to deal with financial instruments that possess such terms.

Understandability and accessibility

63. To some extent the impairment requirements of the standard are a reflection of the complexities of the modern world, but we believe the requirements are complex and difficult to understand, especially by non-financial entities for whom the requirements were not aimed towards.

64. Going forward, ICAEW believes there is a larger role for the profession to offer more education to aid with interpretation and implementation of complex standards and for preparers and users to engage earlier in their development. We believe the IASB needs to think about the complexities of the rules it is introducing, especially when they do not apply to a broad spectrum of reporters.

© ICAEW 2023