Published on *The National Law Review* https://natlawreview.com

IFRS 9: Impairment of Loans Under the New EU Expected Loss Model

Article By:

Corrado Angelelli

Giuditta Betti

Gianmarco Volino

EU Regulation No 2021/25 of the Commission of 13 January 2021, which took effect on 1 January 2022, amended Regulation No 1126/2008 with the changes previously introduced on 27 August 2020 in “Interest Rate Benchmark Reform - Phase 2 - Amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16,” published by the International Accounting Standards Board (IASB). Subsequent changes were made to the general framework of international accounting practices in EU Regulation No 2021/1080.

The IASB aimed to both simplify certain processes and clarify certain practical doubts raised by users regarding the application of international accounting standards.

One of the most significant changes relates to IFRS 9, which provides precise guidance on the acknowledgement of expected credit losses, stating that an entity must recognise, when appropriate, an allowance for expected losses, based on the *Expected Loss Model*.

The *Expected Loss Model* in IFRS 9 requires that a loan or any amortized financial asset be reported on the balance sheet with its risk of expected loss, regardless of whether the risk has already materialised or will materialise in the future.

Another aspect of the amendment is the new *Three-Bucket Impairment Model* or *ECL Model*. This innovative calculation system classifies loans into three levels which correspond to different methods for calculating potential losses.

The first level is for ***performing*** loans, i.e. exposures that have not exhibited significant increases in credit risk or that have low credit risk at the time of reporting.

The second level is for ***underperforming*** loans, i.e., exposures that have exhibited a significant increase in credit risk since initial recognition. Loans or financial instruments fall into this category in cases of a default of more than 30 days, a downgrade in rating level, or clear economic or financial distress.

The final classification is for ***non-performing*** loans, i.e., exposures with objective evidence of loss at the time of reporting, which are identified in accordance with the procedures for recognising impaired loans. These loans or financial instruments demonstrate significant credit risk which has already manifested in actual loss. A period longer than 90 days without payment would qualify a loan for this level of classification.

These categories are used to evaluate the expected losses of a loan. In the first level, expected losses are measured over a period of 12 months. In the other two levels, where there is a higher probability of default, a time period corresponding to the remaining contractual duration (lifetime) or the natural maturity of the loan is assigned. The "lifetime" of a loan, used for Level 2 loans, is derived from the presumption that in the case of contractual payments being more than 30 days past due, the credit risk of the financial asset has increased significantly since initial recognition. However, the debtor entity may refute this presumption by providing evidence to the contrary pursuant to the principle of "comply or explain," an accepted concept in the field of corporate governance.

The determination of whether credit risk has increased significantly should be based on the most reasonable and sustainable information available without undue cost or effort. This information should include actual and expected changes in external market indicators, internal factors, and borrower-specific information. Additionally, the maximum initial credit risk for a given portfolio by product type and/or region (the "origination credit risk") should be established and compared to the credit risk at the reference date.

National Law Review, Volume XII, Number 46