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Expected Credit Losses – Exposure Draft

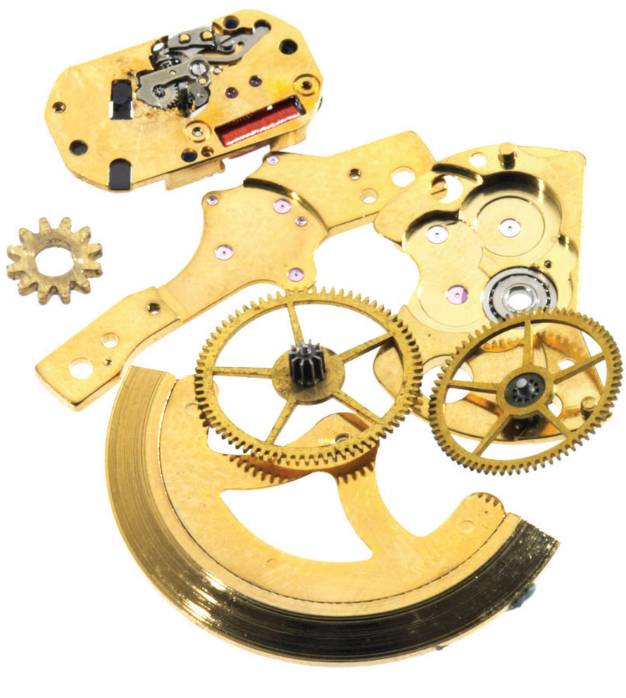
In a nutshell

The exposure draft proposes the following with respect to the recognition, measurement, presentation, and disclosure of expected credit losses:

- One model applies to all financial assets subject to measurement of expected credit losses as well as some loan commitments and financial guarantee contracts.
- In the case of purchased or originated credit impaired financial assets and other financial instruments where credit risk has increased significantly since initial recognition, the loss allowance is measured at an amount equal to lifetime expected credit losses.
- For all other financial instruments subject to the proposals, the loss allowance is measured at an amount equal to the 12-month expected credit losses.
- The estimate of expected credit losses reflects an unbiased and probability-weighted amount (determined by evaluating the range of possible outcomes) as well as the time value of money.
- Depending on the status of a financial asset with regard to credit impairment (reflecting criteria similar to IAS 39 guidance), interest revenue is calculated in different ways.
- The proposals include extensive disclosure requirements that aim to identify and explain the amounts in the financial statements arising from expected credit losses and the effect of deterioration and improvement in the credit risk of financial instruments subject to the proposals.
- Comments on the proposals are due by 5 July 2013.

Background and objective

On 7 March 2013, the International Accounting Standards Board (IASB) issued for public comment an Exposure Draft ED/2013/3 *Financial Instruments: Expected Credit Losses* (the 'ED'). The proposals are intended to replace the guidance on impairment of financial assets in IAS 39 *Financial Instruments: Recognition and Measurement* with new requirements that will form part of IFRS 9 *Financial Instruments*. This follows two previous exposure documents proposing models to account for expected credit losses: an Exposure Draft *Financial Instruments: Amortised Cost and Impairment*, published in November 2009, and a Supplementary Document *Financial Instruments: Impairment*, published jointly with the Financial Accounting Standards Board (FASB) in January 2011. These were issued in response to recommendations by the Financial Crisis Advisory Group (set up by the IASB and FASB) to create an impairment model that uses more forward looking information in order to achieve earlier recognition of credit losses as compared to currently used 'incurred loss models' that delay recognition of credit losses until the occurrence of a loss event.



The objective of the proposals is to establish principles for the recognition, measurement, presentation, and disclosure of expected credit losses that will provide useful information for users of financial statements in their assessment of the amount, timing, and uncertainty of future cash flows.

The proposals

Scope

The ED proposes that the same impairment model apply to all of the following:

- financial assets measured at amortised cost in accordance with IFRS 9;
- financial assets mandatorily measured at fair value through other comprehensive income (FVTOCI) in accordance with Exposure Draft ED/2012/4 *Classification and Measurement: Limited Amendments to IFRS 9*;
- loan commitments when there is a present obligation to extend credit (except where these are measured at fair value through profit and loss (FVTPL) under IFRS 9);
- financial guarantee contracts to which IFRS 9 is applied (except those measured at FVTPL); and
- lease receivables within the scope of IAS 17 *Leases*.

Observations

- In contrast with current IAS 39 requirements (where the measurement of impairment for amortised cost assets and available for sale (AFS) debt instruments is very different), the proposals would result in the same measurement of impairment for financial assets measured at amortised cost and those debt instruments classified under the proposed FVTOCI category.
- The application of the impairment methodology to loan commitments and financial guarantee contracts (subject to certain exceptions) is different to the present IFRS requirements which result in measurement being in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

General approach

Expected credit losses are required to be measured through a loss allowance in accordance with one of two approaches:

- at an amount equal to the 12-month expected credit losses (expected credit losses that result from those default events on the financial instrument that are possible within 12 months after the reporting date); or
- at an amount equal to full lifetime expected credit losses (expected credit losses that result from all possible default events over the life of the financial instrument).

The latter approach is required to be applied to a financial instrument if the credit risk of that financial instrument has increased significantly since initial recognition and also to all purchased or originated credit-impaired financial assets (see section below), as well as to trade receivables that do not constitute a financing transaction in accordance with IAS 18 *Revenue.* Additionally, under the proposals entities could elect as a matter of accounting policy to apply the approach to trade receivables that do constitute a financing transaction in accordance with IAS 18 and as a separate accounting policy choice to apply the approach to lease receivables. For all other financial instruments, expected credit losses are measured at an amount equal to the 12-month expected credit losses.

Significant increase in credit risk

With the exception of purchased or originated credit-impaired financial assets, the loss allowance for financial instruments is measured at an amount equal to lifetime expected losses if the credit risk of a financial instrument has increased significantly since initial recognition, unless the credit risk of the financial instrument is low at the reporting date. The ED proposes that credit risk is considered low if a default is not imminent and any adverse economic conditions or changing circumstances may lead to, at most, a weakened capacity for the borrower to meet its contractual cash flow obligations on the instrument (with the proposals including an example of a loan that has an internal credit rating equivalent to the external credit rating of ‘investment grade’).

The assessment of whether there has been a significant increase in credit risk is based on an increase in the probability of a default occurring since initial recognition. Under the ED, an entity may use various approaches to assess whether credit risk has increased significantly (provided that the approach is consistent with the proposals). An approach can be consistent with the proposals even if it does not include an explicit probability of default occurring as an input. The proposed application guidance provides a list of factors that may assist an entity in making the assessment. Also, whilst in principle the assessment of whether a loss allowance or provision should be based on lifetime expected credit losses is to be made on an individual basis, an entity may perform this assessment on a collective basis (for example, on a portfolio basis) if the financial instruments have shared risk characteristics that are indicative of the borrowers' ability to pay all of the amounts due in accordance with the contractual terms.

The proposals also contain a rebuttable presumption that the credit risk has increased significantly when contractual payments are more than 30 days past due. The ED also proposes that (other than for purchased or originated credit-impaired financial instruments) if a significant increase in credit risk that had taken place since initial recognition and has reversed by a subsequent reporting period (i.e., cumulatively credit risk is not significantly higher than at initial recognition) then the expected credit losses on the financial instrument revert to being measured based on an amount equal to the 12-month expected credit losses.

Purchased or originated credit-impaired financial assets

Purchased or originated credit impaired financial assets are treated differently because the asset is credit impaired at initial recognition. For these assets, an entity would recognise *changes* in lifetime expected losses since initial recognition as a loss allowance with any changes recognised in profit or loss. Under the proposals, any favourable changes for such assets are an impairment gain even if the resulting expected cash flows of a financial asset exceed the estimated cash flows on initial recognition.

Purchased or originated credit-impaired financial assets are defined as purchased or originated financial assets that have objective evidence of impairment on initial recognition. Objective evidence of impairment is in turn defined as one or more events that have occurred and have an impact on the expected future cash flows of the financial instruments. It includes observable data that has come to the attention of holder of the financial instrument about the following events:

- significant financial difficulty of the issuer or borrower;
- a breach of contract (such as a default or delinquency in interest or principal payments);
- the lenders for economic or contractual reasons relating to the borrowers financial difficulty granted the borrower a concession that would not otherwise be considered;
- it becoming probable that the borrower will enter bankruptcy or other financial reorganisation;
- the disappearance of an active market for the financial asset because of financial difficulties; or
- the purchase of a financial asset at a deep discount that reflects incurred credit losses.

Observations

The definition of objective evidence of impairment is based on the existing criteria in IAS 39 as to when a financial asset is impaired. Importantly, under paragraph 59 of IAS 39, the objective evidence of impairment has to be as a result of one or more events that occurred after initial recognition whereas this is not necessarily the case for purchased or originated credit-impaired financial assets under the ED.

Basis for estimating expected credit losses

Any measurement of expected credit losses under the proposals shall reflect an unbiased and probability-weighted amount that is determined by evaluating the range of possible outcomes as well as incorporating the time value of money. Expected credit losses are defined in the ED as the weighted average of credit losses with the respective probabilities of default as the weightings. For example, if the credit loss of CU100 has a 5 per cent probability of default occurring and a 95 per cent probability of no default occurring, this results in an expected credit loss of CU5. Whilst an entity does not need to consider every possible scenario, it must consider the possibility of credit losses even if that probability is low. In particular, an entity is required to estimate: for 12-month expected credit losses, the probability of default occurring on the financial instrument in the next 12 months, and for lifetime expected credit losses, the probability of a default occurring on the financial instrument during its remaining life. An entity is required to incorporate the best available information (i.e., that which is reasonably available, including information about past events, current conditions, and reasonable and supportable forecasts of future events and economic conditions at the reporting date). Information is reasonably available if obtaining it does not involve undue cost or effort (with information available for financial reporting purposes qualifying as such). An entity will consider the probability of a default occurring on the loan commitment or, for financial guarantee contracts, the probability of a default occurring of the specified debtor. An entity may use practical expedients when estimating expected credit losses if they are consistent with the principles in the proposals (for example, expected credit losses on trade receivables may be calculated using a provision matrix).

The discount rate used to reflect time value shall, for a financial asset, be determined at initial recognition as a reasonable rate that is between (and including) the risk-free rate and the effective interest rate. For undrawn loan commitments and financial guarantee contracts, the discount rate should reflect the current market assessment of time value of money and the risks that are specific to the cash flows but only to the extent that such risks are not taken into account by adjusting the discount rate.

Observation

The proposals are clear in stating that even for an individual financial asset, the measurement of expected credit losses must include the probability weighting of credit losses even if these are unlikely and the most probable outcome is the collection of the full contractual cash flows and zero credit losses. The proposals in effect prohibit an entity from estimating expected credit losses solely on the basis of the most likely outcome.

Modifications and write-offs

If a renegotiation or other modification of the contractual cash flows of a financial asset does not result in derecognition under IFRS 9, the entity shall recalculate the gross carrying amount of the financial asset (i.e., carrying amount before taking account of any loss allowance). This is done by discounting the new expected cash flows (post modification) at the original effective interest rate (or where applicable, the revised effective interest as a result of fair value hedge accounting) and recognising any resulting modification gain or loss in profit or loss. From this date, the entity assesses whether the credit risk of a financial instrument has increased significantly since initial recognition by comparing the credit risk at the reporting date (under modified terms) and the credit risk at initial recognition (under original, unmodified terms).

The proposals require an entity to directly reduce the gross carrying amount of a financial asset (carrying amount before any loss allowance for impairment losses) when the entity has no reasonable expectations of recovery. The ED states that a write off constitutes a derecognition event and may relate to either the asset in its entirety or a portion of it.

Presentation

Whilst interest revenue is always required to be presented as a separate line item, it is calculated differently according to the status of the asset with regard to credit impairment. In the case of a financial asset that is not a purchased or originated credit-impaired financial asset and for which there is no objective evidence of impairment at the reporting date, interest revenue is calculated by applying the effective interest rate method to the gross carrying amount ("gross method" for the purposes of this publication).

In the case of a financial asset that is not a purchased or originated credit-impaired financial asset but for which there is objective evidence of impairment at a reporting date, interest revenue is calculated by applying the effective interest rate to the amortised cost balance, which comprises the gross carrying amount adjusted for any loss allowance ("net method" for the purposes of this publication). If following a period of using the net method, the amount of expected credit loss decreases and can be related objectively to an event since the net method was applied, the calculation of interest revenue reverts to the gross method.

Finally, in the case of purchased or originated credit-impaired financial assets, interest revenue is recognised by applying a credit-adjusted effective interest rate to the amortised cost balance at initial recognition. The credit-adjusted effective interest rate is the rate that discounts the cash flows expected on initial recognition (explicitly taking account of expected credit losses as well as contractual terms of the instrument) back to the amortised cost at initial recognition.

The proposals require that impairment losses, including reversals of impairment losses and impairment gains (in the case of purchased or originated credit-impaired financial assets), are presented in a separate line item in the statement of profit or loss and other comprehensive income.

Observation

The trigger point for the change in presentation of interest income on financial assets (from the gross method to the net method) is based on objective evidence of impairment and is different from the trigger point for a change in the amount at which expected credit losses are measured from 12-month expected credit losses to lifetime expected credit losses (which is based on a significant deterioration in the credit risk of a financial asset).

Disclosure

General

The ED proposes extensive disclosure requirements. The focus of these is on information that identifies and explains the amounts in the financial statements that arise from expected losses and the effect of deterioration and improvement in credit risk of financial instruments. The disclosures are required to be given either in the financial statements or by including a cross reference to other statements (such as a risk report) available to users of financial statements on the same terms and at the same time. For the purposes of the proposed disclosure requirements, financial assets, loan commitments, and financial guarantee contracts are grouped into classes appropriate to the nature of the information being disclosed and that take into account the characteristics of those financial assets. An entity is also required to present sufficient information to permit reconciliation to the line items that are presented in the statement of financial position.

Reconciliations

An entity would be required to provide a reconciliation from the opening balance to the closing balance of the amortised cost of financial assets, showing separate reconciliations for the gross carrying amount and the associated loss allowance for the following:

a) financial assets with a loss allowance measured at an amount equal to 12-month expected credit losses;

b) financial assets with a loss allowance measured at an amount equal to lifetime expected credit losses;

c) financial assets that have objective evidence of impairment at the reporting date but are not purchased or originated credit-impaired financial assets; and

d) purchased or originated credit-impaired financial assets (in addition, in this case, disclosure is required of the total amount of undiscounted expected credit losses at initial recognition).

In addition, a reconciliation of movements in the provision is required for loan commitments and financial guarantee contracts.

Write-offs and modifications

An entity is required to disclose its write off policy including whether any assets written off are still subject to enforcement activity and the nominal value of such assets.

For financial assets whose contractual cash flows have been modified during the financial period and whose loss allowance is equal to lifetime expected losses, the entity shall disclose the amortised cost and gain or loss on modification as well as disclosing at each reporting date subsequent to the modification:

a) the gross carrying amount of financial assets for which the loss allowance changed from being based on lifetime expected losses to 12-month expected losses; and

b) re-default rates on financial assets that have been modified while in default.

Estimating credit losses

An entity shall explain the inputs, assumptions, and estimation techniques used when estimating 12-month and lifetime expected credit losses and is required to disclose in particular: the basis of inputs and the estimation techniques used (as well as any change in technique used and reason for that change), an explanation of the changes in estimates of expected credit losses and the cause of the change, and information about the discount rate used to reflect the effect of time value of money in measuring expected credit losses (including the discount rate chosen by the entity, its percentage value, and any significant assumptions made in its determination).

Collateral & other

In respect of financial assets, loan commitments, or financial guarantees secured by collateral or other credit enhancements, the proposals would require disclosure of the following:

a) a description of the collateral and other credit enhancements, discussion of its quality, and explanation of any changes in quality stemming either from deterioration or changes in the entity's collateral policies;

b) the gross carrying amount of financial assets with expected credit losses of zero due to collateral; and

c) for financial assets with objective evidence of impairment at the reporting date, quantitative information about the extent to which collateral or other credit enhancements reduce the severity of credit loss.

Entities are required to disclose quantitative and qualitative analyses of significant positive or negative effects on the loss allowance caused by a particular portfolio or geographical area.

Effect of change in credit risk

The proposals would require an entity to explain the inputs, assumptions, and estimation techniques used when determining whether the credit risk of financial instruments has increased significantly since initial recognition and when determining if there is objective evidence of impairment. In particular, an entity shall disclose: the basis of inputs, the estimation technique, an explanation of any changes in these, and the reasons for these changes. Additionally, to the extent that the entity has rebutted the presumption that assets more than 30 days past due have a significant increase in credit risk, the entity shall disclose how that presumption has been rebutted.

The ED proposes that entities disclose, by credit risk rating grades, the gross carrying amount of financial assets and provision amount for loan commitments and financial guarantee contracts. Disclosure is disaggregated between those items subject to 12-month expected losses and those subject to lifetime expected losses, with further disaggregation for trade and lease receivables for which lifetime expected losses apply, and separate disclosure for purchased or originated credit-impaired financial assets. The ED proposes that the number of credit grades is at least three and subject to this condition shall not exceed the number used for internal credit risk management purposes. Additionally, the number of grades within these constraints shall be sufficient to enable a user of the financial statements to assess the entity's exposure to credit risk.

In addition, an entity shall, under the proposals, disclose the gross carrying amount of financial assets and the amount recognised as a provision for loan commitments and financial guarantee contracts that are assessed on an individual basis and whose credit risk has increased significantly since initial recognition.

Effective date and transition

The effective date for the requirements will be established after the IASB redeliberates comments received to the ED. The effective date of IFRS 9 (into which the proposals in this ED will be incorporated) is annual periods beginning on or after 1 January 2015 with earlier application permitted.

The ED proposes that its requirements are applied retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* except that the entity is not required to restate prior periods (but may restate them, if and only if, this is possible without the use of hindsight). If the entity does not restate prior periods, it shall adjust the opening balance of retained earnings (or other appropriate component of equity) at the beginning of the annual reporting date that includes the date of initial application. Additionally, the entity is not required to apply the requirements retrospectively if, at the date of initial application, determining the credit risk on initial recognition of a financial instrument would require undue cost or effort. In such a case, the loss allowance (and specifically whether it is equal to 12 month or lifetime expected losses) is determined on the basis of whether the credit risk is low at each reporting date rather than whether there has been significant increase in credit risk of the financial instrument since initial recognition.

On the date of initial application, an entity would be required to disclose the information that would permit the reconciliation of the ending impairment balances under IAS 39 or the provision under IAS 37 to the opening loss allowances or provisions determined in accordance with the requirements of the ED. For financial assets, this disclosure would be provided by the related financial assets' measurement categories in accordance with IAS 39 and IFRS 9, and shall show separately the effect of changes in measurement category on the loss allowances at that date.

Convergence with U.S. GAAP

Whereas the previous proposal on impairment issued by the IASB (in the form of Supplementary Document *Financial Instruments: Impairment*, issued in January 2011) represented joint proposals with the FASB, the current proposals are different from the U.S. standard setter's proposals as per the Proposed Accounting Standards Update *Financial Instruments – Credit Losses* (Subtopic 815-15) issued on 20 December 2012.

The FASB's proposals do not include a dual-measurement approach to expected credit losses (i.e., 12-month and lifetime expected losses) like the IASB's proposals. Instead, the FASB's proposals would apply a measurement of expected credit losses based on full lifetime expected losses in all cases. In many other aspects, both proposals share common features.

The comment periods on the ED and the FASB's proposals overlap, with comments due on the FASB's proposals by 30 April 2013. The overlapping comment period will enable interested parties to compare the proposals. The IASB and the FASB plan to discuss jointly the comments received on their respective proposals after the comment periods end. This will provide each Board with the opportunity to consider the views received by the other and for the Boards to consider whether it is possible to more closely align their expected credit loss models.

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