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Need to know
Meeting of the IFRS Transition Resource Group for Impairment of Financial Instruments

Contents

Introduction

Topic 1 – Significant increases in credit risk

Topic 2 – Use of changes in the risk of a default occurring over the next 12 months when assessing for significant increases in credit risk

Topic 3 – Measurement of expected credit losses for revolving credit facilities

Topic 4 – Forward-looking information

Topic 5 – Status of Basel guidance on accounting for expected credit losses

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This Need to know summarises the second meeting of the IFRS Transition Resource Group for Impairment of Financial Instruments ('ITG', 'the group') which took place on 16 September 2015.

Introduction

The ITG is a discussion forum established by the International Accounting Standards Board (IASB) to provide support for stakeholders on implementation issues arising from the new impairment requirements following the issue of IFRS 9 *Financial Instruments (2014)*.

Overall, the purpose of the ITG is to:

- solicit, analyse and discuss stakeholder issues arising from implementation of the new impairment requirements;
- inform the IASB about those implementation issues, which will help the IASB determine what, if any, action will be needed to address those issues; and
- provide a public forum for stakeholders to learn about the new impairment requirements from others involved with implementation.

During the meetings, the ITG members share their views on the issues discussed and following the meeting the IASB issues a meeting summary. The IASB will determine what action, if any, will be taken on any issues discussed. See the IASB's **website** for further information about the ITG and the agenda papers discussed.

The meeting was attended by ITG members, Basel representatives, the IASB staff ('the staff') and some IASB board members, one of whom chaired the meeting ('the Chair'). The views expressed at the meeting did not represent authoritative views of the IASB.

This meeting was the second of three planned meetings for the group in 2015. Further meetings beyond 2015 have intentionally not been planned to allow for a stable platform for implementation which is already underway for many institutions. The next meeting is planned for 11 December 2015. To allow the staff sufficient time to analyse any new submissions, the Chair requested submissions be received before 21 October 2015 if they are to be considered at the December meeting. The Chair also noted that although no further physical meetings of the ITG are scheduled; the ITG will stand ready to assist on any significant impairment implementation issues.

The staff provided a brief summary of issues that had been submitted to the group (which is available on the IASB's **website**) and noted that out of seven submissions, six were discussed at this first meeting (some issues have been grouped together). The seventh submission, along with any other new submissions, will be discussed at the next meeting on 11 December 2015.

In addition to a discussion of the issues submitted, one the Basel representatives also provided an update on the status of the Basel guidance on accounting for expected credit losses (see Topic 5 below).

Topic 1 – Significant increases in credit risk

Background

Two issues relating to how an entity should determine whether there has been a significant increase in credit risk were discussed by the ITG.

Issue 1

The first issue related to how an entity should determine whether there has been a significant increase in credit risk for a portfolio of loans where identical pricing and contractual terms are applied to customers across broad credit quality bands, for example, most retail loans. The submitter had presented a specific example where a bank held a portfolio of large volume of relatively small value individual loans which are assigned internal credit risk grades from one (lowest credit risk) to ten (highest credit risk). For a particular product, the maximum credit risk acceptable at origination is a credit grade of five (i.e. a customer is only accepted if their credit grade is five or lower). Once accepted the contractual terms and pricing of the product are identical for all customers taking up the product (regardless of grade). A key question for this issue was whether it would be appropriate for the bank to use a single threshold such as a breach of a specific credit grade for determining whether there has been a significant increase in credit risk.

The submitter had noted that because the same contractual terms were offered to all customers in the portfolio it could be argued that a single threshold could be appropriate. For example, as long as the current credit grade of the loan did not exceed the maximum acceptable grade for originating the product (i.e. credit grade five) it did not result in an economic loss because the product would have been priced the same if it were newly originated and therefore would not represent a significant increase in credit risk.

Issue 2

The second issue related to whether an entity can use behavioural indicators of credit risk as a proxy for the assessment of significant increases in credit risk since initial recognition. The submitter specifically considered the following examples of behavioural indicators which it also thought could be used to demonstrate that a financial instrument had low credit risk (in accordance with IFRS 9:5.5.10):

(a) where a customer has made only the minimum monthly repayment for a specified number of months;

(b) where a customer has failed to make a payment on a loan with a different lender; or

(c) where a customer has failed to make a specified number of minimum monthly repayments.

See ITG **Agenda Paper 1** for additional details.

Summary

Issue 1

In the introduction of the issue the staff noted that under IFRS 9 the objective is to recognise lifetime expected credit losses when there has been a significant increase in credit risk since initial recognition and emphasised that the model is based on a relative increase of credit risk rather than an absolute measure of credit risk. Consequently a smaller increase in credit risk will be more significant for a higher credit quality asset compared to a lower credit quality asset.

In the ITG discussion it was acknowledged that Example 6 in the IFRS 9 (paragraphs IE40-IE42) illustrates how an absolute approach might be used to identify significant increases in credit risk, however, in that example, all significant increases in credit risk would be captured by the approach given the specific fact pattern presented. In contrast, in the submitter's scenario it would be inappropriate to assume that because the pricing for credit grades one to five are the same that there is no significant increase in credit risk for movements within those grades. This is because, as noted in IFRS 9:B5.5.17, although pricing is a relevant indicator of changes in credit risk other factors are also relevant and therefore one cannot rely solely on pricing. Therefore, an absolute approach using internal credit risk grades is only appropriate if it captures significant increases in credit risk.

During the discussion a number of ITG members talked about the use of internal credit grades more generally and noted that not all internal credit grading systems will be appropriate for identifying a significant increase in credit risk. For example, internal credit grades may not be reviewed frequently enough or they may not include any forward looking information and therefore care needs to be taken when considering internal credit grading systems as it should not be assumed that all systems are fit for purpose. Also when such systems are used they may need to be supplemented with additional analysis (e.g. a portfolio level to capture effects not captured at the individual level).

It was also noted that credit risk analysis may need to be performed on a sub-portfolio level to ensure the portfolio is homogenous from an initial credit risk point of view. More generally, it was acknowledged that a vast variety of rating methodologies and frameworks can coexist even in a single institution and that the practical interpretation of a significant increase in credit risk should be adapted for these different contexts while ensuring compliance with the model.

It was emphasised by the Chair that the objective of the portfolio assessment is to determine whether there has been a significant increase in credit risk at an individual level and that a portfolio assessment cannot be used to obscure significant increases in credit risk that exist at the individual level. Furthermore it was noted that there should be appropriate segmentation in order to perform portfolio assessments for assets with shared credit risk characteristics.

Issue 2

The staff introduced the topic by reminding everyone that IFRS 9 does not mandate specific approaches for identifying significant increases in credit risk and therefore allows some flexibility provided the objective of the model is met. The staff also mentioned that credit risk would be expected to significantly increase before an asset becomes passed due and therefore forward looking information is relevant for identifying significant increases in credit risk.

A number of ITG members noted that relying solely on behavioural indicators as identified by the submitter would not be sufficient to identify significant increases in credit risk because it would not capture all reasonable and supportable information that is available without undue cost or effort. In particular it would not capture forward looking information. ITG members noted that behavioural information identified by the submitter can be used for certain exposures provided other sources of information are also considered, both internal and external, such as pre-delinquency indicators (e.g. increase in utilisation of credit lines, cash withdrawals on credit cards, etc.) and that forward looking information is also incorporated (e.g. as part of a top-down approach).

It was also noted that although IFRS 9:5.5.23 allows an entity to use its own methods to determine if an instrument has low credit risk, it must be consistent with a globally understood definition of low credit risk. The Chair and other ITG members questioned whether it would be possible for the behavioural measures identified by the submitter to ever meet this criterion and therefore the indicators would not be appropriate for identifying low credit risk assets.

Some noted that behavioral indicators and scores can be more predictive for short term defaults (e.g. up to 12 months) and less indicative as the time horizon increases. Consequently, whether a behavioral score established at origination could be used as a reference for a significant increase in credit risk should be questioned with regard to the nature of the portfolio.

Topic 2 – Use of changes in the risk of a default occurring over the next 12 months when assessing for significant increases in credit risk

Background

The issue raised by the submitter related to the use of changes in the risk of a default occurring over the next 12 months as an approximation of the changes in the lifetime risk of a default occurring when assessing for significant increases in credit risk. Specifically, the submitter asked whether, and if so to what extent, an entity would be required to perform an annual review to determine whether circumstances still support the use of a 12-month approximation of changes in the lifetime risk of default occurring.

See ITG Agenda Paper 2 for additional details.

Summary

In the introductory analysis the staff noted that the Standard does not require a specific approach for identifying a significant increase in credit risk and allows for an entity to use changes in the risk of default occurring over the next 12 months to determine whether credit risk has increased significantly since initial recognition if it is a reasonable approximation of the changes in lifetime risk of a default occurring.

The Chair emphasised that in order for changes in 12 month probability of default to be a reasonable proxy for lifetime probability default there should not be default patterns concentrated at specific points during the expected life of the exposure. Others also emphasised that the appropriateness of using an approach based on changes in 12 month probability of default would also depend on appropriate segmentation of the portfolio (e.g. by term to maturity).

Once it was established, based on a robust analysis, that a change in 12 month probability of default was an appropriate proxy for lifetime probability, a number of ITG members agreed that although it would be necessary to reassess this assertion on an on-going basis it would not necessarily require the same detailed analysis as that performed at the outset. For example, one could look to identify any changes in circumstances that could affect the original conclusion, i.e. perform a qualitative analysis rather than a quantitative analysis.

If, based on the subsequent analysis, it was determined that changes in 12 month probability of default is no longer an appropriate proxy for changes in lifetime probability of default it was noted that an entity would have to move to a different approach to assess significant increases in credit risk.

One ITG member noted that even where an entity used changes in 12 month probability of default for identifying significant increases in credit risk, lifetime probability of defaults would still be relevant for measuring expected credit losses.

Another ITG member also stressed the importance of the disclosure requirements on how the assessment of significant increase in credit risk is performed and which factors are taken into account which would include information about when changes in 12 month probability of default is used as a proxy for changes in lifetime probability of default.

Topic 3 – Measurement of expected credit losses for revolving credit facilities

Background

The issue raised by the submitter related to the application of the impairment requirements to a portfolio of revolving credit facilities. The issue related to how an entity should estimate future drawdowns on undrawn lines of credit when an entity has a history of allowing customers to exceed their contractually set credit limits on their overdrafts and other revolving credit facilities such as credit cards. In particular, should the potential exposure at default that is used to determine expected credit losses include potential exposures beyond the contractual credit limit?

See ITG Agenda Paper 3 for additional details.

Summary

The Staff introduced the issue by noting that the definition of credit losses in IFRS 9 are the difference between contractual cash flows that are due to an entity and the cash flows that the entity expects to receive and therefore does not consider cash flows outside of the contractual terms.

ITG members began the debate by discussing the credit risk management practices surrounding revolving credit facilities such as credit cards. It was noted that operationally, lenders would have 'floor limits' which represent credit limits that are above the credit limit disclosed to the customer in the credit agreement. These higher floor limits are used to determine potential exposures at default for credit risk management purposes. Therefore, in practice the credit risk not only goes beyond the contractual commitment period for the revolving credit facility (e.g. goes beyond the one day commitment period for a credit card) but can also go beyond the specified credit limit in the credit agreement (i.e. for future exposures both tenor and amount that go beyond the contractual terms are considered).

It was noted that some retail portfolios such as credit cards are managed on an aggregated basis in terms of credit risk management and that in the retail business, exposures are usually not grouped on a client basis.

It was noted by the Chair and acknowledged by some ITG members that the exception to deviate from the contractual terms of a credit exposure in IFRS 9:5.5.20 was a limited exception that only allows an entity to extend the period that the entity is exposed to credit risk for certain revolving credit facilities. It does not permit an entity to increase the amount of the exposure beyond the contractually committed amount.

One ITG member noted that this difference between the accounting and the risk management practices could result in accounting provisions not being sufficient to cover the credit losses expected from a credit risk management perspective and represent another difference to regulatory provisions.

One of the Board members, and also the staff, emphasised the point that the Standard only includes a limited exception to go beyond the contractual terms of the exposure when measuring expected credit losses (i.e.to go beyond the committed period) and felt that if a special case for exposures beyond the contractual credit limit for this specific circumstance was permitted this could have further knock-on consequences for other scenarios.

One ITG member questioned whether the contractual credit limit was relevant once an entity looked beyond the committed period because there was effectively no credit commitment beyond the committed period.

In conclusion of the debate the Chair re-emphasised that the model is based on contractual terms which includes the contractual credit limit and therefore it would not be appropriate to analogise the specific exception outlined in IFRS 9:5.5.20 relating to the contractual commitment period to the contractual credit limit. The Chair also noted that the Board would be informed about the difference between the credit risk management view and the accounting requirements in this respect.

Topic 4 – Forward-looking information

Background

Two submitters raised issues regarding the use of forward-looking information in determining significant increases in credit risk of a financial asset and on measuring expecting credit losses.

Issue 1

Whether forward-looking information (e.g. indicators, forecasts of future economic conditions and scenarios) should be incorporated into impairment reviews differently, for example, on a country by country, bank by bank or portfolio by portfolio basis.

Issue 2

How to determine what is 'reasonable and supportable' forward-looking information about emerging issues and uncertain future events to include in the measurement of expected credit losses.

For this issue, the submitter noted different sources of forward looking information:

(a) macroeconomic assumptions and forecasts and other more detailed data that is currently used by an entity for budgeting and forecasting purposes, including consensus forecasts by third-party providers; and

(b) other forward looking information on emerging issues and uncertain future events that are not usually included in the entity's current budgeting and forecasting processes (the examples provided for this included the Scottish Referendum on 18 September 2014 for which there was significant uncertainty about the voting outcome and the consequences; and the possibility of a future Greek exit from the Eurozone).

See ITG Agenda Paper 4 for additional details.

Summary

Issue 1

The discussion for Issue 1 was brief and noted that forward looking information is relevant to different portfolios in different ways depending on the characteristics of the portfolio. For example, one piece of macroeconomic forward looking information might be relevant for a specific portfolio but not relevant for another portfolio.

Issue 2

The discussion for Issue 2 was longer and highlighted some significant challenges in respect of appropriately incorporating forward looking information into the model. It was noted that incorporating reasonable and supportable forward looking information without undue cost or effort is challenging but is an essential feature of the impairment model.

An ITG member observed that entities are at different stages of sophistication with incorporating forward looking information into their models and methodologies are expected to become more refined over time. Other members noted that in some cases it will require significant judgement to determine what is reasonable and supportable forward looking information.

During the debate it was emphasised that even though an event may be remote or have a low likelihood of occurrence, it may still be relevant and need to be captured because the objective is to determine expected credit losses which represents a weighted average of credit losses taking into account 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. Therefore all events should be at least considered to determine if they are relevant and if relevant assess the consequences.

Some ITG members noted that determining the consequences of an event may initially be challenging, however, that did not mean it could be ignored and over time the consequences of an event could become clearer leading to more accurate estimation of the potential consequences through the passage of time. However, some ITG members noted that if there is no credible basis for estimating the effect of an event then this should be disclosed rather than recognising expected credit losses based on unreliable information. The Chair acknowledged that disclosures should explain both what has been included and excluded in applying the model and that entities should make best efforts (without undue cost or effort) to determine and recognise the effect of emerging events.

A number of ITG members noted that there is a risk of double counting expected losses in respect of emerging events if they are also included in long term historic credit risk information used to measure expected losses or if there is overlap between different emerging events (i.e. different events that could have the same consequences) and the losses in respect of those events are recognised separately without adjustments.

Given the need for significant judgement in using forward looking information some ITG members noted the need for robust governance over the use of such information and the use of overlays to capture their effect. Ultimately it will be necessary to step back and conclude if the overall outcome is consistent with the overall objective of the model.

Topic 5 – Status of Basel expected loss guidance

At the meeting, one of the Basel representatives gave a debrief on status of the final Basel guidance on accounting for expected credit losses which follows the initial Consultative Document issued in February 2015.

In summary the guidance is expected to be issued before the end of the year after approval by the Basel Committee Board and consultation with the IASB and US FASB to ensure it is not inconsistent with the accounting requirements. The structure is expected to be consistent with the Consultative Document, i.e. main body applies to expected losses generally, with an appendix on IFRS 9 application. It was noted that the guidance will apply to internationally active banks applying advanced IRB and not standardised banks which would be considered by jurisdictional regulators. The guidance will:

- cover materiality and proportionality;
- acknowledge that the impairment model is a symmetrical model (i.e. will cater for both increases and decreases in credit risk when measuring expected credit losses, however, the focus of prudential regulators is on deterioration in credit risk);
- emphasise the need for forward looking information to be incorporated into the model;
- add factors to consider when assessing significant increases in credit risk;
- limit practical expedients as was noted in the Consultative Document, e.g. it will not be appropriate to assess credit risk based solely on past due status because for internationally active banks it is reasonable and supportable that forward looking information is available without undue cost or effort; and
- not add new disclosure requirements.

Deloitte LLP is a limited liability partnership registered in England and Wales with registered number OC303675 and its registered office at 2 New Street Square, London EC4A 3BZ, United Kingdom. Tel: +44 (0) 20 7936 3000 Fax: +44 (0) 20 7583 1198.

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