

IFRS in Focus

Meeting of the IFRS Transition Resource Group for Impairment of Financial Instruments

Contents

Introduction

Topic 1 – Meaning of current effective interest rate

Topic 2 – Collateral and other credit enhancements and the measurement of expected credit losses

Topic 3 – Inclusion of cash flows expected from the sale on default of a loan in the measurement of expected credit losses

Topic 4 – Assessing for significant increases in credit risk for financial assets with a maturity of less than 12 months

Topic 5 – Measurement of the loss allowance for credit impaired financial assets

Topic 6 – Presentation of the loss allowance for financial assets measured at amortised cost

Topic 7 – Scope of paragraph 5.5.20 of IFRS 9

Topic 8 – Measurement of expected credit losses for charge cards

Topic 9 – Period over which to measure expected credit losses for revolving credit facilities

Topic 10 – Incorporation of forward looking scenarios

This IFRS in Focus summarises the meeting of the IFRS Transition Resource Group for Impairment of Financial Instruments ('ITG', 'the group') which took place on 11 December 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, a Basel representative, 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 final scheduled meeting for the group and covered all of the remaining questions that had been submitted to the group (the submission log is available on the IASB's [website](#)). Further meetings beyond 2015 have intentionally not been planned to allow for a stable platform for implementation which is already underway for many institutions. However, at the meeting the Chair noted that there were no plans to disband the ITG and questions can continue to be submitted through the IASB's website. Any questions received will be added to the submission log and a decision will be made as to what further action will be taken to address the issue (e.g. the issue could be addressed with further educational material).

For more information please see the following websites:

www.iasplus.com

www.deloitte.com

Below is a summary of the issues discussed at the meeting.

Topic 1 – Meaning of current effective interest rate

Background

The topic discussed related to the appropriate discount rate to use when measuring expected credit losses for a floating rate financial asset. IFRS 9 requires the time value of money to be taken into account when measuring expected credit losses and requires the 'current effective interest rate' to be used for discounting expected credit losses for a financial instrument with a variable interest rate.

The question raised for the ITG was what is meant by the 'current effective interest rate' for a floating rate financial asset when an entity recognises interest income in each period based on the actual floating rate applicable to that period.

An example was presented to the ITG with two different views as to what represents the 'current effective interest'.

Example: A financial asset has a remaining maturity of 10 years and bears a floating rate of interest indexed to 12-month LIBOR (the credit spread is assumed to be zero for the purposes of this example):

- the LIBOR rate is reset at the end of each year;
- at the reporting date, 12-month LIBOR is 2 per cent per annum and is expected to increase to 10 per cent per annum at the time the last coupon is reset; and
- interest income is recognised using the 12-month LIBOR rate at the reporting date—i.e. 2 per cent.

View 1: the LIBOR rate that is current as at the reporting date—in the example, a rate of 2 per cent per annum applied to all cash shortfalls; or

View 2: the LIBOR rates derived from the current yield curve—in the example, a rate of 2 per cent per annum applied to cash shortfalls arising during Year 1 and the applicable LIBOR rates derived from the current yield curve for each of the subsequent cash flows.

See ITG Agenda [Paper 7](#) for additional details.

Summary

During the discussion a number of ITG members noted that view 1 was a more natural reading of the requirements in IFRS 9 and would be more operational to apply in practice but that view 2 could also apply under IFRS 9. The chair agreed that either the 12 month rate or the current yield curve could be used under IFRS 9 for the example presented. It was emphasised that the rate used should be applied consistently for forecasting the contractual cash flows, forecasting the cash shortfalls, discounting the cash flows and revenue recognition. It was also noted that the notion of effective interest rate and the meaning of 'current effective interest rate' under IFRS 9 had not changed from IAS 39 *Financial Instruments: Recognition and Measurement*.

Topic 2 – Collateral and other credit enhancements and the measurement of expected credit losses

Background

This submission was about the inclusion of cash inflows from collateral and other credit enhancements, such as insurance and financial guarantee contracts, in the measurement of expected credit losses. When measuring expected credit losses under IFRS 9, the definition of credit loss states that cash flows that are considered shall include cash flows from credit enhancements that are integral to the contractual terms. IFRS 9.B5.5.55 also states that the estimate of expected cash shortfalls is required to reflect cash flows expected from credit enhancements that are part of the contractual terms and are not recognised separately by the entity. Given these requirements the following questions were raised:

- what is meant by 'part of the contractual terms and not recognised separately by the entity'?
- must the credit enhancement be an explicit term of the related asset's contract to be taken into account in the measurement of expected credit loss?

See ITG Agenda [Paper 5](#) for additional details

Summary

In presenting the issue the staff noted, and ITG members agreed, that the term 'integral to the contractual terms' is not defined in IFRS 9 and is not limited to the explicit terms in the contract of the financial asset being assessed for impairment. Furthermore, credit enhancements that are recognised separately by an entity are not included in the measurement of expected credit losses to avoid double counting. Consequently, expected cash flows from credit enhancements that are 'integral to the contractual terms' of the financial asset and are not accounted for separately should be taken into account when measuring expected credit losses.

A standalone credit default swap was given as an example of a credit enhancement that would not be included in the measurement of expected credit losses because it would be separately recognised.

It was noted by a number of ITG members that in practice it will require judgement to determine whether a credit enhancement is "integral" to the contractual terms and that judgement is already required when measuring impairment losses under IAS 39.

Topic 3 – Inclusion of cash flows expected from the sale on default of a loan in the measurement of expected credit losses

Background

This submission was about the inclusion, in the measurement of expected credit losses, of cash inflows expected to be recovered through the sale of a financial asset to a third party after it is in default.

The submitter noted that, in practice, the amounts due on a defaulted loan can be recovered in a variety of ways. For example, the amounts due can be recovered:

- using the entity's internal collections personnel to recover cash directly from the borrower;
- using an external collections agency who, for a fee, recovers cash directly from the borrower and passes this to the lender;
- through seizing and selling any collateral (using the entity's own employees or using external agents); or
- through selling the asset to a third party (e.g. a specialist buyer of distressed debt).

This leads to the question of whether the sale of the loan itself can be considered an expected cash flow when measuring expected credit losses. This question is relevant because the projected loan sale price, discounted by the effective interest rate from the point of the loan sale to the reporting date, can be significantly different from the cash flows the entity would otherwise expect to recover directly from the borrower discounted by the effective discount rate to the measurement date.

See ITG Agenda [Paper 6](#) for additional details

Summary

The staff noted that expected credit losses are a probability weighted estimate of credit losses, which are the present value of the cash shortfalls, being the difference between:

- the contractual cash flows that are due to the entity; and
- the cash flows that the entity expects to receive.

In accordance with the definition of credit loss in IFRS 9 'an entity shall estimate cash flows by *considering all contractual terms* of the financial instrument' (emphasis added). Consequently, the staff noted that the definition of credit losses does not explicitly require expected cash flows to be derived solely from the contractual terms or solely from the borrower (consistent with the approach discussed in topic 2 above) and could include cash flows from the sale of the asset if the entity had the intention and ability to recover cash flows on defaulted loans through sale to third parties.

A number of ITG members supported this position and noted that if an entity was legally restricted from selling the loan or did not intend to recover cash flows from a sale then the cash flows from a sale would not be relevant in measuring expected credit losses. Furthermore the ability to include cash flows from sale did not mean that the fair value of an asset could simply represent a floor to the recovery of cash flows for recognised financial assets. The approach should only consider cash flows from an expected sale in a default scenario (in the same way that cash flows from realising collateral are only considered in a default scenario). However, it was explained that this did not mean that cash flows from sale are only relevant for financial assets in stage three of the impairment model but could also be used as part of the probability weighted scenarios for measuring expected losses for assets in stage one and stage two. Essentially the cash flows from sale can be used to determine the loss given default for assets where a sale to recover cash flows was expected (e.g. it could be estimated that a certain percentage of loans that go into default will be sold to a third party for a certain price). In practice, the expectation of recovery through sale would be expected to be evidenced in some way (e.g. based on past practice) and should consider market conditions (e.g. an entity cannot assume that past sales at past prices would necessarily be achievable in the future). It was agreed amongst the members that the sale cash flow used in measuring expected credit losses would be net of selling costs (i.e. net cash flows recovered).

Topic 4 – Assessing for significant increases in credit risk for financial assets with a maturity of less than 12 months

Background

This issue related to whether an entity is required to assess for significant increases in credit risk in respect of financial instruments with a maturity of less than 12 months but none of the exceptions in IFRS 9 that permit or require the use of lifetime expected losses apply to the instrument (i.e. it is not a trade receivable, lease receivable or contract asset). For such assets where the 12-month expected credit loss allowance equals the lifetime expected credit loss allowance, monitoring whether there has been a significant increase in credit risk in respect of these assets will not be relevant for the purpose of measuring expected credit losses.

The question arises because paragraphs 35H and 35M of IFRS 7 *Financial Instruments: Disclosures* require disclosures that distinguish between financial instruments for which the loss allowance is equal to 12-month expected credit losses and financial instruments for which the loss allowance is equal to lifetime expected credit losses and the costs associated with such an assessment could be significant. The following two views were presented:

View A – Yes, it is necessary to assess for significant increases in credit risk the short-term financial assets that have a maturity of less than 12 months and for which 12-month expected credit losses equal lifetime expected credit losses.

View B – No, it is not necessary to assess for significant increases in credit risk the short-term financial assets that have a maturity of less than 12 months and for which 12-month expected credit losses equal lifetime expected credit losses.

See ITG Agenda [Paper 8](#) for additional details

Summary

The staff noted that unless a specific exception applies, an entity is required to measure 12-month expected credit losses in respect of financial instruments that have not suffered a significant increase in credit risk since initial recognition and lifetime expected credit losses in respect of financial instruments that have suffered a significant increase in credit risk since initial recognition. Furthermore, the exceptions in IFRS 9 (paragraphs 5.5.13-5.5.16) do not apply to all financial instruments with a maturity of less than 12 months. Consequently, unless a specific exception applies, it is required under the model, and the disclosure requirements of IFRS 7 to identify assets that have exhibited a significant increase in credit risk and those that have not.

ITG members agreed with the staff and noted that although the measurement basis for expected losses might be the same for short term assets, the measurement of expected losses for those with a significant increase in credit risk would be higher (because of the credit deterioration) and these should be separately identified. It was noted that the potential life of an asset could change since inception and also that the tracking of credit risk would be consistent with credit risk management.

Topic 5 – Measurement of the loss allowance for credit impaired financial assets

Background

IFRS 9:5.4.1 notes that interest revenue shall be calculated by applying the effective interest rate to the gross carrying amount of a financial asset ('gross interest revenue'). However for financial assets that are not purchased or originated credit-impaired financial assets and have subsequently become credit-impaired financial assets, the entity shall calculate interest revenue by applying the effective interest rate to the 'amortised cost' of the financial asset ('net interest revenue').

In this submission, the submitter asked for guidance about how to measure the gross carrying amount and the loss allowance for financial instruments that are measured at amortised cost and are credit-impaired (but not purchased or originated credit-impaired) and suggested three different approaches for calculating the loss allowance. These are illustrated using the following simplified example:

Entity X holds a financial asset measured at amortised cost, that was not credit-impaired on purchase or origination. The gross carrying amount of the asset (before deducting the loss allowance) was CU100 on 31 December 20X1. The effective interest rate is 10 per cent. The asset becomes credit-impaired on 31 December 20X1 and the loss allowance is determined to be CU60. Accordingly the asset has an amortised cost of CU40 at 31 December 20X1.

At 31 December 20X2, there have been no cash settlements and no change in the expected timing or amount of cash flows on the asset. For simplicity it is assumed that on applying the effective interest rate, interest revenue for the 12 months to 31 December 20X2 will be CU4 = CU40 × 10 per cent, in accordance with IFRS 9:5.4.1(b) and the amortised cost of the asset at 31 December 20X2 will be CU44 = CU40 + (CU40 × 10 per cent).

The possible approaches to calculating the loss allowance and gross carrying amount at 31 December 20X2 are:

Approach A: The gross carrying amount is discounted using the effective interest rate of 10 per cent. Hence at 31 December 20X2, the gross carrying amount is CU110 = CU100 + (CU100 × 10 per cent). The loss allowance is calculated as the balancing figure between the gross carrying amount and the amortised cost. Because both the gross carrying amount and amortised cost have been calculated by applying the effective interest rate, the loss allowance will also be discounted at the effective interest rate of 10 per cent. At 31 December loss allowance is CU66 = CU110 – CU44 (or CU60 + (CU60 × 10 per cent)).

Approach B: The loss allowance remains constant at CU60. The gross carrying amount is calculated as the balancing figure between amortised cost and the loss allowance. In other words, the gross carrying amount is increased by the amount of the interest revenue for the period ending 31 December 20X2 of CU4. At 31 December 20X2 the gross carrying amount is CU104 = CU44 + CU60 (or CU100 + CU4).

Approach C: The gross carrying amount remains constant at CU100. The loss allowance is calculated as the balancing figure between the gross carrying amount and the amortised cost. In other words, the corresponding amount of the interest revenue of CU4 is debited to the loss allowance in its entirety. At 31 December 20X2 the loss allowance would be CU56 = CU100 – CU44 (or CU60 – CU4).

The submitter noted that each approach gives rise to a different combination of gross carrying amount and loss allowance subsequent to the financial asset becoming credit-impaired. However, the resulting amortised cost is the same for each approach. The following table summarises the outcome of the three approaches at 31 December 20X2 in this simplified example:

	A	B	C
Gross carrying amount	110	104	100
Loss allowance	(66)	(60)	(56)
Amortised cost	44	44	44

See ITG Agenda [Paper 9](#) for additional details

Summary

It was acknowledged by a number of ITG members that there is diversity in practice when entities use a loss allowance as permitted under IAS 39. This stems from the fact that IAS 39 does not provide explicit guidance on the measurement of the loss allowance. However, in contrast, IFRS 9 is clear that the loss allowance should be discounted by the effective interest rate and consequently only Approach A is permitted under IFRS 9. In discussing the example used to illustrate the issue, it was noted that the increase in the loss allowance of CU6 under Approach A would not be recognised as an impairment charge in profit or loss but corresponds to an equal increase in the gross carrying amount.

Topic 6 – Presentation of the loss allowance for financial assets measured at amortised cost

Background

This submission requested to know whether an entity is required, for financial assets measured at amortised cost, to present the loss allowance separately in the statement of financial position.

The submitter noted that amortised cost is defined in Appendix A of IFRS 9 as “the amount at which the financial asset or financial liability is measured at initial recognition minus the principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount and, for financial assets, adjusted for any loss allowance” and IFRS 9:5.5.2 requires that for financial assets measured at fair value through other comprehensive income “the loss allowance shall not reduce the carrying amount of the financial asset in the statement of financial position”.

Further, IFRS 7:16A states that “an entity shall not present the loss allowance separately in the statement of financial position as a reduction of the carrying amount of the financial asset”.

See ITG Agenda [Paper 10](#) for additional details

Summary

The staff noted, and ITG members agreed, that neither IFRS 9 nor IFRS 7 contains any explicit requirements regarding the presentation of the loss allowance in respect of financial assets measured at amortised cost (or trade receivables, contract assets or lease receivables) in the statement of financial position. Furthermore, in accordance with paragraph 54 of IAS 1 *Presentation of Financial Statements*, the loss allowance is not included in the list of line items to be presented in the statement of financial position as a minimum, although IAS 1 does require an entity to consider what is relevant to the financial statements.

Consequently, an entity may choose to present additional information on the face of the financial statements and disaggregate the gross carrying amount and loss allowance components of the amortised cost balance if it wished to. It was noted however, this choice only relates to what is presented on the face of the financial statements because IFRS 7 has specific requirements regarding the disclosure of the loss allowance in the notes to the financial statements.

Topic 7 – Scope of paragraph 5.5.20 of IFRS 9

Background

IFRS 9:5.5.19 stipulates that the maximum period to consider when measuring expected credit losses is the maximum contractual period (including extension options) over which the entity is exposed to credit risk and not a longer period, even if that period is consistent with business practice. However, IFRS 9:5.5.20 introduces an exception to these requirements in respect of the period to consider when measuring expected credit losses for specific financial instruments such as revolving credit and overdraft facilities that are managed on a collective basis. This exception is to address the fact that limiting the period to consider expected credit losses to the contractual period would result in expected credit losses being measured over a very short period, which would not reflect the underlying economics or the way in which these facilities were managed.

In accordance with IFRS 9:5.5.20, the type of financial instruments within its scope are described as those that include both a loan and an undrawn component and the entity’s contractual ability to demand repayment and cancel the undrawn commitments does not limit the entity’s exposure to credit losses to the contractual notice period. IFRS 9:B5.5.39 sets out what are considered to be the general characteristics of such financial instruments and specifically notes that one of those characteristics is that these financial instruments do not have a fixed term or repayment structure.

In this submission, the submitter asked whether the general characteristics described in IFRS 9:B.5.5.39 should be considered required characteristics or merely examples of typical characteristics of financial instruments in scope of IFRS 9:5.5.20. In particular, the submitter questioned whether either of the following characteristics would prevent a facility from being within the scope of IFRS 9:5.5.20:

- Scenario 1: If an immediately revocable (i.e. at the discretion of the lender) facility has a fixed maturity, e.g. five years; or
- Scenario 2: If an immediately revocable facility has no fixed maturity but when drawn, can take the form of a loan with a fixed maturity, e.g. five years (i.e. once drawn, the lender no longer has the right to demand immediate repayment at its discretion).

The submitter also set out some typical characteristics of credit facilities where lenders advance multipurpose revocable credit facilities where a fixed limit can be used in a number of different ways (e.g. revolving overdraft, variable or fixed rate loan (with or without a fixed term), an amortising loan, etc).

See ITG Agenda [Paper 2](#) for additional details

Summary

During the discussion it was noted that it is necessary to determine the unit of account to which IFRS 9 is applied to, and because a multi-purpose facility is set out in a single document does not necessarily mean that it is a single unit of account (e.g. within a single document there could be a loan, a commitment for a specific loan, a loan facility, etc). In some cases the assessment of the unit of account may require judgement.

It was also noted that IFRS 9:5.5.20 sets out the specific scope of the exception to look beyond the contractual period of exposure and that the features noted in IFRS 9:5.5.39 are relevant to consider but on their own are not determinative as to whether the exception in IFRS 9:5.5.20 applies.

A key characteristic of the financial instruments to which the IFRS 9:5.5.20 exception applies is that it can have a drawn and undrawn balance and both are managed together on the basis of one set of cash flows from the borrower (i.e. relating to both drawn and undrawn elements).

Consequently, ITG members agreed that the exception in IFRS 9:5.5.20 could be applied to Scenario 1 but not to Scenario 2. Scenario 1 could meet the scope exception because the facility can have drawn and undrawn components and although there is a maximum period of availability of five years, it does not negate the lender's contractual ability to cancel the undrawn commitment immediately and demand repayment of any drawn element, and as such the cash flows of the drawn and undrawn components can be considered together. However, in Scenario 2 the cash flows of the five year term loan could not be combined with the cash flows relating to the undrawn loan commitment because the term loan has a five year repayment structure which is not short term and the undrawn element is immediately revocable (i.e. once drawn, the drawn and undrawn elements would not be considered together as a single cash flow). ITG members agreed therefore, from inception of the facility, the scope exception in IFRS 9:5.5.20 would not apply in Scenario 2. It was noted however, that where the repayment structure of drawn amounts were short term (e.g. 30 days), the drawn element and the undrawn element could be managed together and the exception in IFRS 9:5.5.20 could apply. Therefore, where the term of the drawn element is less than five years, judgement would have to be exercised to determine if the exception in IFRS 9:5.5.20 applies.

Topic 8 – Measurement of expected credit losses for charge cards

Background

The issue discussed related to the application of the impairment requirements to a particular type of credit facility that does not have a stated contractual credit limit.

The fact pattern presented in the submission considered a scenario where a charge card is issued to retail customers where there is no stated credit limit and the lender approves charges (i.e. customer transactions) at the time of sale and the lender can suspend the ability to make charges or cancel the card account at its discretion and balances are always due in full at the end of each month.

The submitter noted that the discussions which took place during the [September ITG meeting](#) reaffirmed that IFRS 9 limits the estimation of future drawdowns on a revolving credit facility falling within the scope of IFRS 9:5.5.20 to the contractually agreed credit limit. Consequently, the submitter sought to understand how a revolving credit facility with no stated absolute credit limit, such as the in the fact pattern presented, should be treated.

See ITG Agenda [Paper 3](#) for additional details

Summary

ITG members discussed whether, in the absence of a written contractual term stating a credit limit, the credit limit could be determined with reference to internal credit limits. Some thought this would be appropriate, however, some felt that this could be inconsistent with the conclusions reached at the September ITG meeting. Following a discussion, it was concluded that the credit limit to be used in the measurement of expected credit losses on revolving credit facilities with not stated absolute credit limit would depend on the specific facts and circumstances.

Based on the specific fact pattern presented in the submission, ITG members agreed that if the lender approves each lending transaction on the card at the point of sale and has the unconditional right to refuse approval, and exercises that right in practice, the undrawn element of the card account does not represent a firm commitment to provide credit and therefore would not fall within the scope of the impairment requirements.

Topic 9 – Period over which to measure expected credit losses for revolving credit facilities

Background

IFRS 9:5.5.20 requires, for certain financial instruments that include both a loan and an undrawn commitment (e.g. certain revolving credit facilities), an entity is required to measure expected credit losses over the period that the entity is exposed to credit risk *and expected credit losses would not be mitigated by credit risk management actions* even if that period extends beyond the maximum contractual period. IFRS 9:B.5.5.40 provides further guidance and refers to determining the period over which the entity is expected to be exposed to credit risk, but for which expected credit losses would not be mitigated by the entity's *normal credit risk management actions*. These requirements were discussed at the [April ITG meeting](#) where it was noted that because the entity's ability to take credit risk management actions could result in a shorter period of exposure than that indicated by the behavioural life, it would not be appropriate for an entity to assume that the behavioural life is always equal to the period over which it is exposed to credit risk.

The key questions on this topic for discussion were summarised as follows:

Question 1: How should an entity determine the starting-point of the maximum period to consider when measuring expected credit losses in accordance with IFRS 9:5.5.20 & B5.5.40?

Question 2: How should an entity determine the ending-point of the maximum period to consider when measuring expected credit losses in accordance with IFRS 9:5.5.20 & B5.5.40? In particular when considering the meaning of 'credit risk management actions':

- (a) should an entity consider all credit risk management actions that the entity is legally and operationally able to take, or only those that the entity expects to take;
- (b) should an entity consider only those credit risk management actions which serve to mitigate credit risk or all credit risk management actions – i.e. including actions that do not mitigate credit risk such as the reinstatement of previously curtailed credit limits; and
- (c) within the context of credit risk management actions which serve to mitigate credit risk, should an entity consider only credit risk management actions that serve to terminate the exposure or whether they should include other actions that limit the exposure in some way.

See ITG Agenda [Paper 4](#) for additional details

Summary

With respect to Question 1, the staff noted and ITG members agreed, that the starting point of the period to consider when measuring expected credit losses for all financial instruments, including those within the scope of IFRS 9:5.5.20 should be the reporting date because an entity is required to measure lifetime or 12-month expected credit losses at each reporting date.

When considering which credit risk management actions to consider in limiting the period of exposure, ITG members agreed an entity is required to consider the actions it *expects* to take rather than the actions it *could* take (i.e. it is based on the period over which the entity is *expected* to be exposed to credit risk). It was also noted that the expected actions to be taken would consider the entity's policies and procedures and take into account reasonable and supportable information, the actions taken in the past and expectations of the future.

ITG members also agreed that only credit risk management actions that serve to *mitigate* credit risk should be considered and therefore the reinstatement of credit limits following a cure would not be considered in measuring expected credit losses. This is because such actions do not serve to mitigate credit risk and the measurement of expected credit losses is limited to the maximum period of credit exposure (i.e. reinstatement of the credit limit is in the control of the lender to extend further credit and therefore is not included in the measurement of expected credit losses).

When considering credit risk management actions that are expected to be taken, it was observed by a number of ITG members that this would most likely have to be done on a segmented basis as the actions for different segments could be different. Segments of exposures within the different stages of the model and drawn and undrawn elements would be considered separately when considering the period of exposure due to the different credit risk management actions expected to be taken. For example, the drawn element would consider the recovery period and the undrawn element would consider expectations of future drawdowns including credit risk management actions expected to be taken to mitigate the credit exposure which may not be relevant to the drawn element (e.g. the expected life of the undrawn element could be limited by reducing or removing the credit limit, however, this would not limit the life of the exposure of the drawn element).

It was also observed that the credit risk management actions to be taken into account would include any actions expected to be taken that could limit the exposure in some way and would not be limited to the actions that serve to terminate the exposure. However, it was noted that a full credit review of an existing customer would not by itself result in limiting the period of credit exposure. In such cases it would be necessary to determine whether the full credit review is expected to result in actual credit risk management actions that mitigate expected credit losses.

Finally, it was noted that an entity should consider the disclosure requirements of IFRS 7 which include disclosures regarding inputs, assumptions and estimation techniques used to apply the impairment requirements of IFRS 9 and any additional disclosures necessary to meet the overall objective of the credit risk disclosures.

Topic 10 – Incorporation of forward looking scenarios

Background

Measuring expected credit losses

IFRS 9:5.5.17 & 18 require expected credit losses to be measured in a way that, among other things, reflects:

- (a) an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes, including the possibility that a credit loss occurs and the possibility that no credit loss occurs; and
- (b) incorporates information about forecasts of future economic conditions.

It was noted in the submission that when calculating expected credit losses, an entity may consider a variety of forecasts and needs to determine how to incorporate that information into its measurement of expected credit losses; and that there seems to be potential for diversity in practice over whether, and how, to incorporate multiple economic forecasts or scenarios, particularly in respect of banks' retail portfolios.

In the submission it was also observed that an economist (either in-house or external to the entity) will typically forecast a single central economic scenario, based on the economist's best estimate or most likely outcome. For example, an economist could be asked to provide a range of plausible forward-looking scenarios, and their associated likelihoods, that underpin their forecast of the single central economic scenario. As a simplified illustration, an economist could predict that future unemployment is most likely to be 5 per cent over the next year, but could plausibly be 4 per cent (with a 20 per cent likelihood), 5 per cent (with a 50 per cent likelihood) or 6 per cent (with a 30 per cent likelihood).

This topic considered whether more than one forward-looking economic scenario is needed when *measuring* expected credit losses and if so, how should different forward-looking scenarios be incorporated into the measurement of expected credit losses.

Assessing for significant increases in credit risk

IFRS 9:B5.5.15 states that when determining whether the recognition of lifetime expected credit losses is required, an entity shall consider reasonable and supportable information that is available without undue cost or effort that may affect the credit risk on a financial instrument in accordance with IFRS 9:5.5.17(c). IFRS 9:5.5.17(c) sets out the principles for measuring expected credit losses in a way that reflects reasonable and supportable information.

This topic also considered whether more than one forward-looking economic scenario is needed, and how to incorporate different forward-looking economic scenarios, when *assessing* significant increases in credit risk.

See ITG Agenda [Paper 1](#) for additional details

Summary

Measuring expected credit losses

When introducing the topic, the staff reiterated and ITG members agreed, that a key objective of the measurement requirements of the IFRS 9 impairment model is that expected credit losses represent an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes, including the possibility that a credit loss occurs and the possibility that no credit loss occurs.

During the discussion it was noted that this did not mean that only one default scenario would necessarily be sufficient because a method for measuring expected credit losses based on a single central forward looking economic scenario could, depending on the specific facts and circumstances give rise to a bias outcome when the probability of default and the credit loss for a range of different forward looking scenarios is non-linear (e.g. credit losses based on 4,5, or 6 per cent unemployment is CU30, CU70, CU170 respectively).

To capture further scenarios it was noted that it would not be necessary to capture every possible scenario but that IFRS 9 permits the use of a representative sample of the total population (i.e. selecting sufficient points to cover a reasonable range of outcomes) based on information that is reasonable and supportable and available without undue cost or effort. The further scenarios included should therefore capture any expected non-linearity. Also, the methodology used should be determined considering the characteristics of the specific portfolio and the overall result of using multiple scenarios should represent a probability weighted amount and be neutral rather than represent an overall stress scenario or conservative measure.

When capturing more than one scenario in the probability weighted measure of expected credit losses, it was noted that IFRS 9 does not prescribe specific methods, however, the method adopted must be appropriate for the specific circumstances and consistent with the objectives of IFRS 9 as outlined above. For example, the approach could vary depending on the level of sophistication of an entity, the financial instruments concerned, the availability of information and materiality.

During the discussion it was noted by a number of ITG members that IFRS 9 requires expected credit losses to reflect an entity's *own* expectations of credit losses (which can include multiple scenarios) but in reaching its own views an entity is expected to consider available information and externally sourced information would help to demonstrate that the entity's own expectations are reasonable and supportable. In assessing an entity's own expectations consideration would also be given to other internal information (e.g. internal budgets) to assess for consistency and understand the reasons behind any differences.

Some ITG members cautioned that when developing a method to measure expected credit losses care was needed with respect to overly scientific approaches which could give rise to spurious accuracy, increased model risk and operational challenges.

Assessing for a significant increase in credit risk

The staff introduced the discussion noting that in order to achieve consistency between measurement of expected credit losses and the assessment of significant increases in credit risk, the same reasonable and supportable forward-looking information should be taken into consideration for both. Accordingly, if more than one forward-looking economic scenario is needed to determine an unbiased measure of expected credit loss, the same scenarios (i.e. more than one) should be considered when assessing significant increases in credit risk.

However, it was noted that because the measurement of expected credit losses can consider factors that are not relevant to the assessment of significant increase in credit risk the consistency between measurement and assessment only applies where relevant (e.g. changes in value of collateral will affect the measurement of expected credit losses but will only affect the assessment of credit risk if it influences the probability of default).

During the discussion the group considered different methods that had been presented in the agenda paper and concluded the discussion noting that IFRS 9 does not prescribe a specific single method for assessing significant increases in credit risk and various approaches may be acceptable depending on the specific facts and circumstances.

Disclosures

Given the significant judgements required in using forward-looking information in the measurement of expected credit losses and assessing for significant increases in credit risk, the IFRS 7 disclosures regarding how forward-looking information has been incorporated into the determination of expected credit losses and assessment of significant increases in credit risk will be particularly important.

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