Applying IFRS

Impairment of financial instruments under IFRS 9

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Contents

In this issue:

What you need to know

The Expected Credit Loss (ECL) impairment requirements in the new standard, IFRS 9 *Financial Instruments,* are based on an expected credit loss model and replace the IAS 39 *Financial Instruments: Recognition and Measurement* incurred loss model.

The ECL impairment *requirements* must be adopted with the other IFRS 9 requirements from 1 January 2018, with early application permitted

The expected credit loss model applies to debt instruments recorded at amortised cost or at fair value through other comprehensive income, such as loans, debt securities and trade receivables, lease receivables and most loan commitments and financial guarantee contracts.

All entities are required to recognise an allowance for either 12-month or lifetime expected credit losses (ECLs), depending on whether there has been a significant increase in credit risk since initial recognition.

The measurement of ECLs reflects a probability-weighted outcome, the time value of money and the best available forward-looking information.

The need to incorporate forward-looking information means that application of the standard will require considerable judgement as to how changes in macroeconomic factors will affect ECLs. The increased level of judgement required in making the expected credit loss calculation may also mean that it will be more difficult to compare the reported results of different entities. However, entities are required to explain their inputs, assumptions and techniques used in estimating the ECL requirements, which should provide greater transparency in respect of entities' credit risk and provisioning processes.

The need to assess whether there has been a significant increase in credit risk will also require new data and processes.

The effect of the new requirements will be to require larger loss allowances for banks and similar financial institutions and for investors in debt securities. On transition, this will reduce equity and have an impact on regulatory capital. The level of allowances will also be more volatile in future, as forecasts change.

The other major impact will be the application to intercompany loans in the separate financial statements of group companies.

1 Introduction

This publication discusses the new forward-looking expected credit loss (ECL) model as set out in IFRS 9. The ECL requirements must be adopted with the requirements of IFRS 9 for classification and measurement for annual reporting periods beginning after 1 January 2018. Early application is permitted if the IFRS 9 classification and measurement requirements are adopted at the same time.

This is a second edition of a publication we originally produced in early 2015. In the last three years, many of the application issues have been the subject of discussion by the IFRS Transition Resource Group for Impairment of Financial Instruments (ITG) established by the IASB and further guidance has been provided by the IASB in the form of webcasts and by banking regulators. At the same time, many more issues have arisen from implementation projects.

1.1 Brief history and background of the impairment project

During the 2007/08 global financial crisis, the delayed recognition of credit losses that are associated with loans and other financial instruments was identified as a weakness in existing accounting standards. This is primarily due to the fact that the impairment requirements under IAS 39 were based on an incurred loss model, i.e., credit losses are not recognised until a credit loss event occurs. Since losses are rarely incurred evenly over the lives of loans, there was a mismatch in the timing of the recognition of the credit spread inherent in the interest charged on the loans over their lives and any impairment losses that only get recognised at a later date. A further identified weakness was the complexity of different entities using different approaches to calculate impairment.

The development of IFRS 9 was complex and took five and a half years. The history of this process is summarised in our publication International GAAP 2018. Here we focus on some key points of this history that are helpful in understanding the requirements of the standard.

In November 2009 the IASB issued an Exposure Draft – *Financial Instruments: Amortised Cost and Impairment* (the 2009 ED). This proposed an impairment model based on expected losses rather than on incurred losses, for all financial assets recorded at amortised cost. In this approach, the initial ECLs were to be recognised over the life of a financial asset, by including them in the computation of the effective interest rate (EIR) when the asset was first recognised. This would build an allowance for credit losses over the life of a financial asset and so match the recognition of credit losses with that of the credit spread implicit in the interest charged. Subsequent changes in credit loss expectations would be reflected in catch-up adjustments to profit or loss based on the original EIR.

Comments received on the 2009 Exposure Draft and during the IASB's outreach activities indicated that constituents were generally supportive of a model that distinguished between the effect of initial estimates of ECLs and subsequent changes in those estimates. However, they were also concerned about the operational difficulties in implementing the model proposed.

To address these operational challenges and as suggested by the EAP, the IASB decided to decouple the measurement and allocation of initial ECLs from the determination of the EIR (except for purchased or originated credit-impaired financial assets). Therefore, the financial asset and the loss allowance would be measured separately, using an original EIR that is not adjusted for initial ECLs. Such an approach would help address the operational challenges raised and allow entities to leverage their existing accounting and credit risk management

> The IASB has sought to address concerns that the incurred loss model in IAS 39 contributes to the delayed recognition of credit losses.

systems and so reduce the extent of the necessary integration between these systems.[1]

By decoupling ECLs from the EIR, an entity must measure the present value of ECLs using the original EIR. This presents a dilemma, because measuring ECLs using such a rate double-counts the ECLs that were priced into the financial asset at initial recognition. This is because the fair value of the loan at original recognition already reflects the ECLs, so to provide for the ECLs as an additional allowance would be to double count these losses. Hence, the IASB concluded that it was not appropriate to recognise lifetime ECLs on initial recognition. In order to address the operational challenges while trying to reduce the effect of double-counting, as well as to replicate (very approximately) the outcome of the 2009 Exposure Draft, the IASB decided to pursue a dual-measurement model that would require an entity to recognise:[2]

▸ A portion of the lifetime ECLs from initial recognition as a proxy for recognising the initial ECLs over the life of the financial asset

▸ The lifetime ECLs when credit risk had increased since initial recognition (i.e., when the recognition of only a portion of the lifetime ECLs would no longer be appropriate because the entity has suffered a significant economic loss)

It is worth noting that any approach that seeks to approximate the outcomes of the model in the 2009 Exposure Draft, without the associated operational challenges, will include a recognition threshold for lifetime ECLs. This gives rise to what has been referred to as 'a cliff effect', i.e., the significant increase in allowance that represents the difference between the portion that was recognised previously and the lifetime ECLs.[3]

Subsequently, the IASB and FASB spent a considerable amount of time and effort developing a converged impairment model. However, due to concerns raised by the FASB's constituents about the model's complexity, the FASB decided to develop an alternative expected credit loss model. (see 1.4 below).[4]

In March 2013, the IASB published a new Exposure Draft – *Financial Instruments: Expected Credit Losses* (the 2013 ED), based on proposals that grew out of the joint project with the FASB. The 2013 ED proposed that entities should recognise a loss allowance or provision at an amount equal to 12-month credit losses for those financial instruments that had not yet seen a significant increase in credit risk since initial recognition, and lifetime ECLs once there had been a significant increase in credit risk. This new model was designed to:

▸ Ensure a more timely recognition of ECLs than the existing incurred loss model

▸ Distinguish between financial instruments that have significantly deteriorated in credit quality and those that have not

▸ Better approximate the economic ECLs[5]

This two-step model was designed to approximate the build-up of the allowance, as proposed in the 2009 Exposure Draft, but involving less operational complexity. Figure 1 below illustrates the stepped profile of the new model, shown by the solid line, compared to the steady increase shown by the black dotted line proposed in the 2009 Exposure Draft (based on the original ECL

> A two-step model was designed to approximate the build-up of the allowance, as proposed in the 2009 ED, but involving less operational complexity.

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[1] IFRS 9.BC5.92
[2] IFRS 9.BC5.93
[3] IFRS 9.BC5.95
[4] IFRS 9.BC5.112
[5] IASB Snapshot: Financial Instruments: Expected Credit Losses Exposure Draft, March 2013.

assumptions and assuming no subsequent revisions of this estimate). It shows that the two step model first overstates the allowance (compared to the method set out in the 2009 Exposure Draft), then understates it as the credit quality deteriorates, and then overstates it once again, as soon as the deterioration is significant.

Figure 1: Accounting for expected credit losses: 2009 ED versus IFRS 9

Source: Based on illustration provided by the IASB in March 2013 it its snapshot: *Financial Instruments: Expected Credit Losses*, page 9.
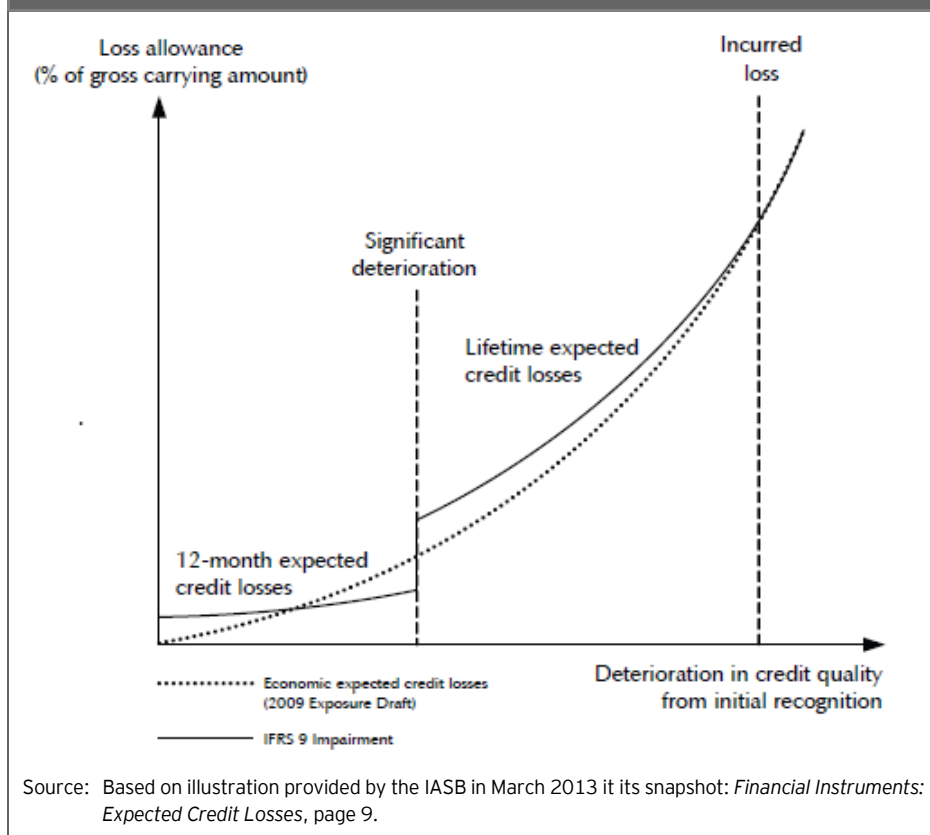
The IASB finalised the impairment requirements and issued them in July 2014, as part of the final version of IFRS 9.

Since then further guidance has been provided from a number of sources:

‣ The IASB set up an IFRS Transition Resource Group for Impairment of Financial Instruments (ITG) (see 1.5 below).

‣ The IASB also has published two webcasts, one on multiple macroeconomic scenarios and another on revolving facilities (see sections 4.6 and 11.2 below).

‣ The Basel Committee provided guidance aimed primarily at internationally active banks on the implementation of the IFRS 9 impairment model (see sections 1.6 and 6.1 below), as has the Enhanced Disclosure Task Force (see section 14.3).

‣ The Global Public Policy Committee has published guidance: (1) to help those charged with governance to identify the elements of a high-quality implementation of IFRS 9 impairment by banks; and (2) to assist audit committees oversee the audit of ECLs (see section 6.2 below).

The IASB issued the impairment requirements in July 2014 as part of the final IFRS 9 and set up an IFRS Transition Resource Group for Impairment of Financial Instruments.

1.2   Overview of IFRS 9 impairment requirements

The new impairment requirements in IFRS 9 are based on an ECL model and replace the IAS 39 incurred loss model. The ECL model applies to debt instruments (such as bank deposits, loans, debt securities and trade receivables) recorded at amortised cost or at fair value through other comprehensive income, plus lease receivables and contract assets. Loan commitments and financial guarantee contracts that are not measured at fair value through profit or loss are also included in the scope of the new ECL model.

The guiding principle of the ECL model is to reflect the general pattern of deterioration, or improvement, in the credit quality of financial instruments. The ECL approach has been commonly referred to as the three-bucket approach, although IFRS 9 does not use this term. Figure 2 below summarises the general approach in recognising either 12-month or lifetime ECLs.

Figure 2: General approach

	Stage 1	Stage 2	Stage 3
Loss allowance updated at each reporting date	**12-month expected credit losses** *credit losses that result from default events that are possible within the next 12 months*	**Lifetime expected credit losses**	
Lifetime expected credit losses criterion		**Credit risk has increased significantly since initial recognition** *whether on an individual or collective basis*	**+ Credit-impaired**
Interest revenue calculated based on	Effective interest rate on gross carrying amount	Effective interest rate on gross carrying amount	Effective interest rate on gross carrying amount less loss allowance

Change in credit risk since initial recognition
Improvement   Deterioration

The amount of ECLs recognised as a loss allowance or provision depends on the extent of credit deterioration since initial recognition. Under the general approach (see 3.1 below), there are two measurement bases:

‣   12-month ECLs (stage 1), which apply to all items as long as there is no significant deterioration in credit risk

‣   Lifetime ECLs (stages 2 and 3), which apply when a significant increase in credit risk has occurred on an individual or collective basis

When assessing significant increases in credit risk, there are a number of operational simplifications available, such as the low credit risk simplification (see section 5.4.1 below).

Stages 2 and 3 differ in how interest revenue is recognised. Under stage 2 (as under stage 1), there is a full decoupling between interest recognition and impairment, and interest revenue is calculated on the gross carrying amount. Under stage 3 (when a credit event has occurred, defined similarly to an incurred credit loss under IAS 39), interest revenue is calculated on the amortised cost (i.e., the gross carrying amount adjusted for the impairment allowance).

The following example illustrates how the ECL allowance changes when a loan moves from stage 1 to stage 3:

Example 1: Expected credit loss allowance in stages 1, 2 and 3 under the general approach

On 31 December 2016, Bank A originates a 10 year loan with a gross carrying amount of $1,000,000, with interest being due at the end of each year and the principal due on maturity. There are no transaction costs and the loan contracts include no options (for example, prepayment or call options), premiums or discounts, points paid, or other fees.

At origination, the loan is in stage 1 and a corresponding 12-month ECL allowance is recognised.

By 31 December 2019, the loan has shown signs of significant deterioration in credit quality and Bank A moves the loan to stage 2. A corresponding lifetime ECL allowance is recognised. In the following year, the loan defaults and is moved to stage 3.

The ECL allowance in each stage is shown below and the detailed calculation is illustrated in Example 3 at 4.4.1 below.

Stage 1: 12-month expected credit losses
On 31 December 2016, the loan is originated. An allowance of $422 is recognised

Stage 2: lifetime expected credit losses
On 31 December 2019, the loan has shown signs of a significant increase in credit risk. An allowance of $50,285 is recognised (the 12-month ECL is $3,495)

Stage 3: lifetime expected credit losses
On 31 December 2020, the loan defaults. An allowance of $262,850 is recognised.

There are two alternatives to the general approach:

▸ The simplified approach, that is either required or available as a policy choice for trade receivables, contract assets and lease receivables (see section 3.2 below)

▸ The credit-adjusted effective interest rate approach, for purchased or originated credit-impaired financial assets (see section 3.3 below)

ECLs are an estimate of credit losses over the life, or the next 12 months, of a financial instrument and when measuring ECLs (see section 4 below), an entity needs to take into account:

▸ The probability-weighted outcome (see section 4.6 below), as ECLs should not be simply either a best or a worst-case scenario, but should, instead, reflect the possibility that a credit loss occurs and the possibility that no credit loss occurs. Following discussion at the ITG, this is understood to include a need to consider multiple economic scenarios (see 4.6 below)

▸ The time value of money (see section 4.7 below)

> The two alternatives to the general approach are: the simplified approach and the credit-adjusted effective interest rate approach.

‣ 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 (see 4.9 below).

1.3 Key changes from the IAS 39 impairment requirements and the impact and implications

The new IFRS 9 impairment requirements eliminate the IAS 39 threshold for the recognition of credit losses, i.e., it is no longer necessary for a credit event to have occurred before credit losses are recognised. Instead, an entity always accounts for ECLs, and updates the loss allowance for changes in these ECLs at each reporting date to reflect changes in credit risk since initial recognition. Consequently, the holder of the financial asset needs to take into account more timely and forward-looking information.

The main implications for both financial and non-financial entities are as follows:

‣ The scope of the impairment requirements is now much broader. Previously, under IAS 39, there were different impairment models for financial assets measured at amortised cost and available-for-sale financial assets. Under IFRS 9, there is a single impairment model for all debt instruments measured at amortised cost and at fair value through other comprehensive income. Furthermore, loan commitments and financial guarantee contracts that were previously in the scope of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* are now in the scope of the IFRS 9 impairment requirements (section 10 below).

‣ Previously, under IAS 39, loss allowances were only recorded for impaired exposures. The new impairment requirements result in earlier recognition of credit losses, by necessitating a 12-month ECL allowance for all credit exposures not measured at fair value through profit or loss. In addition, there will be a larger allowance for all credit exposures that have significantly deteriorated (as compared to the recognition of incurred losses under IAS 39 today). While credit exposures in stage 3, as illustrated in Figure 2 above, are similar to those deemed by IAS 39 to have suffered individual incurred losses, credit exposure in stages 1 and 2 will essentially replace those exposures measured under IAS 39's collective approach.

‣ The ECL model is more forward-looking than the IAS 39 impairment model. This is because holders of financial assets are not only required to consider historical information that is adjusted to reflect the effects of current conditions and information that provides objective evidence that financial assets are impaired in relation to incurred losses, but they are now required to consider reasonable and supportable information that includes forecasts of future economic conditions including, where relevant, multiple scenarios, when calculating ECLs, on an individual and collective basis.

How we see it

▶ The application of the new IFRS 9 impairment requirements is expected to increase the credit loss allowances (with a corresponding reduction in equity on first-time adoption) of many entities, particularly banks and similar financial institutions. However, the increase in the loss allowance will vary by entity, depending on its portfolio and current practices. Entities with shorter term and higher quality financial instruments are likely to be less significantly affected. Similarly, financial institutions with unsecured retail loans are more likely to be affected to a greater extent than those with collateralised loans such as mortgages.

▶ Moreover, the focus on expected losses will possibly result in higher volatility in the ECL amounts charged to profit or loss, especially for financial institutions. The level of loss allowances will increase as economic conditions are forecast to deteriorate and will decrease as economic conditions are forecast to become more favourable. This may be further compounded by the significant increase in the loss allowance when financial instruments move between 12-month and lifetime ECLs and vice versa. However, the need to consider the effect of multiple macroeconomic scenarios (see 4.6 below) may help to reduce the volatility, depending on the circumstances.

▶ The need to incorporate forward-looking information, including establishing multiple macroeconomic scenarios, determining the probability of their occurrence and assessing how changes in macroeconomic factors will affect ECLs, means that the application of the standard will require considerable judgement. Also, the increased level of judgement required in making the ECL calculation and assessing when significant deterioration has occurred may mean that it will be difficult to compare the reported results of different entities. However, the more detailed disclosures (compared with those required to complement IAS 39) that require entities to explain their inputs, assumptions and techniques used in estimating ECLs requirements, should provide greater transparency over entities' credit risk and provisioning processes. The Enhanced Disclosures Task Force, established in 2012 by the Financial Stability Board to recommend best practice market risk disclosures, has published guidance to promote greater transparency and comparability about the application of the ECL model.

▶ In financial institutions, finance and credit risk management systems and processes have to be better connected, because of the necessary alignment between risk and accounting in the new model. Risk models and data will have to be more extensively used to make the assessments and calculations required for accounting purposes, which are both a major change from IAS 39 and a key challenge.

▶ In addition, financial institutions need to fully understand the complex interactions between the IFRS 9 and regulatory capital requirements in relation to credit losses. The Basel Committee on Banking Supervision has now finalised what it calls an 'interim' approach and transitional arrangements, providing national jurisdictions with a framework for any arrangement. This is contained in the BCBS document Standards – Regulatory treatment of accounting provisions – interim approach and transitional arrangements. However, the long-term regulatory treatment of ECL provisions remains to be determined. In many cases, it is expected that the new IFRS 9 ECL requirements will result in a reduction in the regulatory capital of financial institutions.

Given that the IFRS 9 impairment requirements apply to lease receivables and that the IASB in its project to replace IAS 17 *Leases* decided to eliminate the distinction between finance and operating leases, there was a concern that this could give rise to significant ECL allowances for those that are currently classified as operating leases. However, the IASB, in finalising IFRS 16 *Leases*, decided not to require a similar treatment for lessors as for lessees, so that they will not need to record financial assets for operating leases. With this change in the final standard, the effect of the IFRS 9 impairment requirements for many lessors has been significantly reduced. As the requirement under IFRS 9 is to take into account only those cash flows used to measure the receivable, there is no need to make a provision against future cash flows that are not yet recognised in the statement of financial position. As a result, the new impairment requirements will have a greater impact on lessors of leases that are currently classed as finance leases, particularly if they opt to apply the simplified approach (see section 3.2 below). In such situations, the effect would be to recognise a potentially significant allowance based on the lifetime ECLs of the lease. However, the lessor's 'loan' is in substance collateralised by the leased asset, which will reduce the ECLs.

1.4   Key differences from the FASB's standard

On 16 June 2016, the FASB issued an Accounting Standard Update (ASU), *Financial Instruments – Credit Losses (Topic 326)*, that aims to address the same fundamental issue that the IASB's ECL model (in IFRS 9) addresses, namely the delayed recognition of credit losses resulting from the incurred credit loss model. It is therefore also an ECL model, but it is not the same as the model in IFRS 9. The most significant differences between the FASB's and the IASB's ECL models are, as follows:

▸ The FASB's ECL model (known as the Current ECL or CECL model) will not be applied to debt securities measured at fair value through other comprehensive income (i.e., available for sale securities under US GAAP). Rather, for these securities, the FASB's existing other-than-temporary impairment model will be modified to require an allowance to recognise estimated credit losses rather than a direct write-down, among other things.

The requirements of the US CECL model differ from those of IFRS 9.

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[6] IFRS 9.B5.5.35

- The FASB's ECLs will be calculated based on the losses expected over the remaining contractual life of an asset, considering the effect of prepayments. An allowance for lifetime ECLs will be required when the loan is initially recognised instead of 12-month ECLs. As a result, the FASB's model does not require an entity to assess whether there has been a significant deterioration in credit quality, in contrast to the assessment required by IFRS 9. This is similar to the IFRS 9 simplified approach (see section 3.2 below).

- The FASB's standard is less prescriptive about how ECLs should be measured, in particular, probability weighted outcomes are not required to be considered. On the other hand, the consideration of multiple scenarios should be compatible with the FASB's model.

- For purchased credit-impaired assets defined as 'acquired individual financial assets (or acquired groups of financial assets with shared risk characteristics) that, as of the date of acquisition, have experienced a more-than-insignificant deterioration in credit quality since origination, as determined by an acquirer's assessment', the FASB's model will require an entity to increase the purchase price by the allowance for ECLs upon acquisition. In doing so, the FASB model will gross up the asset's carrying amount by the ECLs existing upon acquisition, but also recognise a corresponding credit loss allowance, thereby resulting in a net carrying amount equal to the purchase price (see section 3.3 below for the accounting treatment of credit-impaired assets under IFRS 9).

- There is no exception for revolving credit facilities (e.g., commitments connected with overdrafts and credit cards) under the FASB's model (see 11 below for the IFRS 9 treatment) and therefore, no impairment allowance is required if the commitment is legally revocable without any conditions.

The FASB standard has tiered effective dates, starting in 2020 for calendar-year reporting public business entities that meet the definition of a U.S. Securities and Exchange Commission (SEC) filer. Early adoption is permitted for all entities but this cannot be before 2019 for calendar-year entities.

1.5 The IFRS Transition Resource Group for Impairment of Financial Instruments (ITG) and IASB webcasts

The IASB has set up an ITG that aims to:

- Provide a public discussion forum to support stakeholders on implementation issues arising from the new impairment requirements that could create diversity in practice

- Inform the IASB about the implementation issues, which will help the IASB determine what action, if any, will be needed to address them[7]

However, the ITG does not issue any guidance.

Members of the ITG include financial statement preparers and auditors from various geographical locations with expertise, skills or practical knowledge on credit risk management and accounting for impairment. Board members and observers from the Basel Committee on Banking Supervision and the International Organisation of Securities Commissions also attend the meetings.

The ITG has had three substantive meetings.

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[7] IASB Website Announcement. IASB to establish transition resource group for impairment of financial instruments, 23 June 2014 and Transition Resource Group for Impairment of Financial Instruments – Meeting Summary, 22 April 2015.

The ITG agenda papers are prepared by the IASB staff and are made public before the meetings. The staff also provides ITG meeting summaries which are not authoritative. Both the staff papers and the meeting summaries represent educational reading on the issues submitted.

Following its inaugural meeting in December 2014 to discuss its operating procedures, the ITG met three times, on 22 April 2015, on16 September 2015, and on 11 December 2015. Although no further meetings have been planned, the group has not been disbanded and stakeholders may continue to submit potential implementation issues following the submission guidelines. Further meetings will be convened if warranted.

On 22 April 2015, the ITG discussed eight implementation issues raised by stakeholders. These included:[8]

▸ When applying the impairment requirements at the reporting date, whether and how to incorporate events and forecasts that occur after economic forecasts have been made, but before the reporting date, and between the reporting period end and the date of signing the financial statements (see section 4.9.3 below)

▸ Whether the impairment requirements in IFRS 9 must also be applied to other commitments to extend credit, in particular, a commitment (on inception of a finance lease) to commence a finance lease at a date in the future and a commitment by a retailer through the issue of a store account to provide a customer with credit when the customer buys goods or services from the retailer in the future (see section 10 below)

▸ Whether there is a requirement to measure ECLs at dates other than the reporting date, namely the date of derecognition and the date of initial recognition (see section 6.3.1 below)

▸ Whether an entity should consider the ability to recover cash flows through an integral financial guarantee contract when assessing whether there has been a significant increase in the credit risk of the guaranteed debt instrument since initial recognition (see section 5.1.1 below)

▸ The maximum period to consider when measuring ECLs on a portfolio of mortgage loans that have a stated maturity of 6 months, but contain a contractual feature whereby the term is automatically extended every 6 months subject to the lender's non-objection (see section 4.5 below)

▸ The maximum period to consider when measuring ECLs for revolving credit facilities and the determination of the date of initial recognition of the revolving facilities for the purposes of assessing them for significant increases in credit risk (see section 11.2 below)

▸ Whether the measurement of ECLs for financial guarantee contracts issued should consider future premium receipts due from the holder and, if so, how (see section 10 below)

▸ The measurement of ECLs in respect of a modified financial asset, the calculation of the modification gain or loss and subsequent requirement to measure ECLs on the modified financial asset as well as the appropriate presentation and disclosure (see section 7.1 below)

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[8] IASB Transition Resource Group for Impairment of Financial Instruments, Meeting Summary, 22 April 2015.

On 16 September 2015, the ITG held its third meeting to discuss six implementation issues raised by stakeholders. These included:[9]

▸ How to identify a significant increase in credit risk for a portfolio of retail loans when identical pricing and contractual terms are applied to customers across broad credit quality bands (see section 5.2.1 below)

▸ The possibility of using behavioural indicators of credit risk for the purpose of the assessment of significant increases in credit risk since initial recognition (see section 5.2.4 below)

▸ When assessing significant increases in credit risk, whether an entity would be required to perform an annual review to determine whether circumstances still support the use of the 12-month risk of a default occurring as an approximation of changes in the lifetime risk of a default occurring (see section 5.4.3 below)

▸ When measuring ECLs for revolving credit facilities, 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 overdrafts and other revolving credit facilities (see section 11.3 below)

▸ At what level should forward-looking information be incorporated – at the level of the entity or on a portfolio-by-portfolio basis (see section 4.9.3 below)

▸ How to determine what is reasonable and supportable forward-looking information and how to treat shock events with material, but uncertain, economic consequences (see section 4.9.3 below)

On 11 December 2015, the ITG held its fourth meeting to discuss eleven implementation issues raised by stakeholders. These included:[10]

▸ What was meant by the 'current EIR' when an entity recognises interest revenue in each period based on the actual floating-rate applicable to that period (see section 4.7 below)

▸ What was meant by 'part of the contractual terms', specifically whether a credit enhancement must be an explicit term of the related asset's contract in order for it to be taken into account in the measurement of ECLs, or whether other credit enhancements that are not recognised separately can also be taken into account (see section 4.8.1 below)

▸ Whether cash flows that are expected to be recovered from the sale on default of a loan could be included in the measurement of ECLs (see section 4.8.2 below)

▸ Application of the revolving credit facilities exception set out in paragraph 5.5.20 of IFRS 9 to multi-purpose facilities (see section 11 below)

▸ How future drawdowns should be estimated for charge cards when measuring ECLs if there is no specified credit limit in the contract (see section 11.3 below)

▸ How an entity should determine the starting-point and the ending-point of the maximum period to consider when measuring ECLs for revolving credit facilities (see section 11.2 below)

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[9] IASB Transition Resource Group for Impairment of Financial Instruments, Meeting Summary, 16 September 2015.
[10] IASB Transition Resource Group for Impairment of Financial Instruments, Meeting Summary, 11 December 2015.

- When measuring ECLs, whether an entity can use a single forward-looking economic scenario or whether an entity needs to incorporate multiple forward-looking scenarios, and if so how (see section 4.6 below)

- When assessing significant increases in credit risk, whether an entity can use a single forward-looking economic scenario or whether the entity needs to incorporate multiple forward-looking scenarios, and if so how (see section 5.7 below)

- Whether there is a requirement to assess significant increases in credit risk for financial assets with a maturity of 12 months or less (see section 5.4.3 below)

- How to measure the gross carrying amount and loss allowance for credit-impaired financial assets that are not purchased or originated credit-impaired and that are measured at amortised cost (see section 13.1.2 below)

- Whether an entity is required to present the loss allowance for financial assets measured at amortised cost (or trade receivables, contract assets or lease receivables) separately in the statement of financial position (see section 13.1 below)

The FASB (see section 1.4 above) has also set up its own Transition Resource Group (TRG) for credit losses and its discussions may prove relevant to the application of IFRS 9 in areas where the two ECL models are similar.

In addition, as part of its activities to support implementation, the IASB has published two educational webcasts since IFRS 9 was published.[11]

- The first, on forward-looking information and multiple scenarios was released on 25 July 2016. It discusses when multiple scenarios need to be considered and the concept of non-linearity, consistency of scenarios, probability-weighted assessment of significant increase in credit risk, and approaches to incorporating forward-looking scenarios (see section 4.6 below).

- The second, on the expected life of revolving facilities was released on 16 May 2017. It focuses on how credit risk management actions would affect the expected life of revolving facilities for the purpose of measuring ECLs (see section 11.2 below).

1.6   Other guidance on expected credit losses

In December 2015, the Basel Committee on Banking Supervision issued its Guidance on accounting for expected credit losses, which sets out supervisory expectations regarding sound credit risk practices associated with implementing and applying an ECL accounting framework (see section 6.1 below).

On 17 June 2016, the Global Public Policy Committee of representatives of the six largest accounting networks (the GPPC) published *The implementation of IFRS 9 impairment by banks – Considerations for those charged with governance of systemically important banks* (the GPPC guidance) to promote a high standard in the implementation of accounting for ECLs. It aims to help those charged with governance to evaluate management's progress during the implementation and transition phase (see section 6.2 below). A year later, on 28 July 2017, the GPPC issued a paper titled *The Auditor's Response to the Risks of Material Misstatement Posed by Estimates of Expected Credit Losses under IFRS 9*.

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[11] IASB website, www.ifrs.org

> The scope of the IFRS 9 ECL model is broader than that of the IAS39 incurred loss model.

2 Scope

IFRS 9 requires an entity to recognise a loss allowance for ECLs on:[12]

‣ Financial assets that are debt instruments such as loans, debt securities, bank balances and deposits and trade receivables (see section 9 below) that are measured at amortised cost[13]

‣ Financial assets that are debt instruments measured at fair value through other comprehensive income (see section 8 below)[14]

‣ finance lease receivables (i.e. net investments in finance leases) and operating lease receivables under IAS 17 and IFRS 16 (when applied) (see section 9.2 below)

‣ Contract assets under IFRS 15 (see 9.1 below). IFRS 15 defines a contract asset as an entity's right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditional on something other than the passage of time (for example, the entity's future performance)[15]

‣ Loan commitments that are not measured at fair value through profit or loss under IFRS 9 (see 10 and 11 below). The scope therefore excludes loan commitments designated as financial liabilities at fair value through profit and loss and loan commitments that can be settled net in cash or by delivering or issuing another financial instrument[16]

‣ Financial guarantee contracts that are not measured at fair value through profit or loss under IFRS 9 (see 10 below)

3 Approaches

In applying the IFRS 9 impairment requirements, an entity needs to follow one of the approaches below:

‣ The general approach (see section 3.1 below)

‣ The simplified approach (see section 3.2 below)

‣ The purchased or originated credit-impaired approach (see section 3.3 below)

Figure 3 below, based on a diagram from the standard, summarises the process steps in recognising and measuring ECLs.

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[12] IFRS 9.5.5.1
[13] IFRS 9.4.1.2
[14] IFRS 9.4.1.2A
[15] IFRS 15 Appendix A, IFRS 9 Appendix A
[16] IFRS 9.2.1(g), 2.3, 4.2.1(a), 4.2.1(d)

Figure 3: Application of the impairment requirements at a reporting date

Is the financial instrument a purchased or originated credit-impaired financial asset? (see 3.3)	→Yes→	Calculate a credit-adjusted effective interest rate and always recognise a loss allowance for changes in lifetime expected credit losses (see 3.3)

↓ No

Is the simplified approach for trade receivables, contract assets and lease receivables applicable? (see 3.2) — Yes →

↓ No

Does the financial instrument have low credit risk at the reporting date? (see 5.4.1) — Yes → Is the low credit risk simplification applied? (see 5.4.1)

No ↓   No ←   Yes →

Has there been a significant increase in credit risk since initial recognition? (see 5) — No →

Recognise 12-month expected credit losses and calculate interest revenue on gross carrying amount (see 4.3)

↓ Yes

Recognise lifetime expected credit losses (see 4.2)

↓ And

Is the financial instrument a credit-impaired financial asset? (see 3.1) — No → Calculate interest revenue on the gross carrying amount (see 3.1)

— Yes → Calculate interest revenue on amortised cost i.e., the gross carrying amount net of loss allowance (see 3.1)

3.1 General approach

Under the general approach, at each reporting date, an entity recognises a loss allowance based on either 12-month ECLs or lifetime ECLs, depending on whether there has been a significant increase in credit risk on the financial instrument since initial recognition.[17] The changes in the loss allowance balance are recognised in profit or loss as an impairment gain or loss.[18]

Essentially, an entity must make the following assessment at each reporting date:

‣ For credit exposures where there have not been significant increases in credit risk since initial recognition, an entity is required to provide for 12-month ECLs, i.e. the portion of lifetime ECLs that represent the ECLs that result from default events that are possible within the 12-months after the reporting date (stage 1 in Figure 2 at section 1.2 above).[19]

‣ For credit exposures where there have been significant increases in credit risk since initial recognition on an individual or collective basis, a loss allowance is required for lifetime ECLs, i.e. ECLs that result from all possible default events over the expected life of a financial instrument (stages 2 and 3 in Figure 2 at section 1.2 above).[20]

   Or

‣ In subsequent reporting periods, if the credit quality of the financial instrument improves such that there is no longer a significant

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[17] IFRS 9.5.5.3, 5.5.5
[18] IFRS 9.5.5.8, Appendix A
[19] IFRS 9.5.5.3, Appendix A
[20] IFRS 9.5.5.4, 5.5.5, Appendix A

increase in credit risk since initial recognition, then the entity reverts to recognising a loss allowance based on 12-month ECLs (i.e., the approach is symmetrical).[21]

It may not be practical to determine, for every individual financial instrument, whether there has been a significant increase in credit risk, because they may be small and many in number and/or because there may not be the evidence available to do so.[22] Consequently, it may be necessary to measure ECLs on a collective basis, to approximate the result of using comprehensive credit risk information that incorporates forward-looking information at an individual instrument level (see section 5.5 below).[23]

To help enable an entity's assessment of significant increases in credit risk, IFRS 9 provides the following operational simplifications:

▸ A low credit risk threshold equivalent to investment grade (see 5.4.1 below), below which no assessment of significant increases in credit risk is required.

▸ The ability to rely on past due information if reasonable and supportable forward looking information is not available without undue cost or effort (see section 5.4.2 below). This is subject to the rebuttable presumption that there has been a significant increase in credit risk if the loan is 30 days past due (see section 5.2.2 below).

▸ Use of a change in the 12-month risk of a default as an approximation for change in lifetime risk (see section 5.4.3 below).

The IFRS 9 illustrative examples also provide the following suggestions on how to implement the assessment of significant increases in credit risk:

▸ Assessment at the counterparty level (see 5.4.4 below)

▸ Asset transfer threshold by determining maximum initial credit risk for a portfolio (see 5.4.5 below)

In stages 1 and 2, there is a complete decoupling between interest recognition and impairment. Therefore, interest revenue is calculated on the gross carrying amount (without deducting the loss allowance). If a financial asset subsequently becomes credit-impaired (stage 3 in Figure 2 at section 1.2 above), an entity is required to calculate the interest revenue by applying the EIR in subsequent reporting periods to the amortised cost of the financial asset (i.e., the gross carrying amount net of loss allowance) rather than the gross carrying amount.[24] Financial assets are assessed as credit-impaired using substantially the same criteria as for the impairment assessment of an individual asset under IAS 39.[25]

A financial asset is credit-impaired when one or more events that have a detrimental impact on the estimated future cash flows of that financial asset have occurred. Evidence that a financial asset is impaired includes observable data about such events. IFRS 9 provides a list of events that are substantially the same as the IAS 39 loss events for an individual asset assessment:[26]

▸ Significant financial difficulty of the issuer or the borrower

▸ A breach of contract, such as a default or past due event

> In Stages 1 and 2, there is a decoupling of interest recognition and impairment.

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[21] IFRS 9.5.5.7
[22] IFRS 9.B5.5.1
[23] IFRS 9.BC5.141
[24] IFRS 9.5.4.1, Appendix A
[25] IAS 39.59, IFRS 9 Appendix A
[26] IFRS 9 Appendix A

- ▸ The lender(s) of the borrower, for economic or contractual reasons relating to the borrower's financial difficulty, having granted to the borrower a concession(s) that the lender(s) would not otherwise consider

- ▸ It is becoming probable that the borrower will enter bankruptcy or other financial reorganisation

- ▸ The disappearance of an active market for that financial asset because of financial difficulties

  Or

- ▸ The purchase or origination of a financial asset at a deep discount that reflects the incurred credit losses

It may not be possible for an entity to identify a single discrete event. Instead, the combined effect of several events may have caused the financial asset to become credit-impaired.[27]

In subsequent reporting periods, if the credit quality of the financial asset improves so that the financial asset is no longer credit-impaired and the improvement can be related objectively to the occurrence of an event (such as an improvement in the borrower's credit rating), then the entity should once again calculate the interest revenue by applying the EIR to the gross carrying amount of the financial asset.[28]

When the entity has no reasonable expectations of recovering the financial asset, then the gross carrying amount of the financial asset should be directly reduced in its entirety. A write-off constitutes a derecognition event (see section 13.1.1 below).

3.2   Simplified approach

The simplified approach does not require an entity to track the changes in credit risk, but, instead, requires the entity to recognise a loss allowance based on lifetime ECLs at each reporting date.[29]

An entity is required to apply the simplified approach for trade receivables or contract assets that result from transactions within the scope of IFRS 15 and that do not contain a significant financing component, or when the entity applies the practical expedient for contracts that have a maturity of one year or less, in accordance with IFRS 15.[30] Paragraphs 60-65 of IFRS 15 provide the requirements for determining the existence of a significant financing component in the contract, including the use of the practical expedient for contracts that have a maturity of one year or less.

A contract asset is defined as an entity's right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditional on something other than the passage of time (for example, the entity's future performance).[31] IFRS 15 describes contracts with a significant financing component as those for which the agreed timing of payment provides the customer or the entity with a significant benefit of financing on the transfer of goods or services to the customer. Hence, in determining the transaction price, an entity is required to adjust the promised

The simplified approach requires the entity to recognise a loss allowance based on lifetime ECLs from origination.

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[27] IFRS 9 Appendix A
[28] IFRS 9.5.4.2
[29] IFRS 9.5.5.15
[30] IFRS 9.5.5.15(a)(i)
[31] IFRS 15 Appendix A

amount of consideration for the effects of the time value of money.[32] However, if the entity expects, at contract inception, that the period between when it transfers a promised good or service to a customer and when the customer pays for that good or service will be one year or less, as a practical expedient, the entity need not adjust the promised amount of consideration for the effects of a significant financing component.[33]

How we see it

Application of the simplified approach to trade receivables and contract assets that do not contain a significant financing component intuitively makes sense. In particular, for trade receivables and contract assets that are due in 12 months or less, the 12-month ECLs are the same as the lifetime ECLs.

However, an entity has a policy choice to apply either the simplified approach or the general approach for the following:[34]

▸ All trade receivables or contract assets that result from transactions within the scope of IFRS 15, and that contain a significant financing component in accordance with IFRS 15. The policy choice may be applied separately to trade receivables and contract assets (see 9.1 below).[35]

▸ All lease receivables that result from transactions that are within the scope of IAS 17 and IFRS 16 (when applied). The policy choice may be applied separately to finance and operating lease receivables (see 9.2 below).[36]

The IASB noted that offering this policy choice would reduce comparability. However, the IASB believes it would alleviate some of the practical concerns of tracking changes in credit risk for entities that do not have sophisticated credit risk management systems.[37]

How we see it

Trade receivables may be sold to a factoring bank, whereby all risks and rewards are transferred to the bank. Consequently, the trade receivables are derecognised by the transferring entity and recognised by the factoring bank which obtains the right to receive the payments made by the debtor for the invoiced amount. In such a case, we believe that the 'factored' trade receivables are outside the scope of the simplified approach for the purpose of the factoring bank applying the IFRS 9 ECL model. This is because the simplified approach is limited to trade receivables that result from transactions within the scope of IFRS 15, i.e., based on a contract to obtain goods or services. This is not the case for the factoring bank since it has acquired the trade receivables through a factoring agreement. Moreover, the simplified approach was introduced to assist entities with less sophisticated credit risk management systems.[38] Factoring banks are likely to have more sophisticated credit risk management systems in place.

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[32] IFRS 15.60
[33] IFRS 15.63
[34] IFRS 9.5.5.16
[35] IFRS 9.5.5.15(a)(ii)
[36] IFRS 9.5.5.15(b)
[37] IFRS 9.BC5.225.
[38] IFRS 9.BC5.104

3.3 Purchased or originated credit-impaired financial assets

On initial recognition of a financial asset, an entity is required to determine whether the asset is credit-impaired. The criteria are set out at section 3.1 above.[39]

A financial asset may be purchased credit-impaired because it has already met the criteria. Such an asset is likely to be acquired at a deep discount. However, this does not mean that an entity is required to apply the credit-adjusted EIR to a financial asset solely because the financial asset has a high credit risk at initial recognition, if it has not yet met those criteria.[40]

It may be also possible that an entity originates a credit-impaired financial asset, for example, following a substantial modification of a distressed financial asset that resulted in the derecognition of the original financial asset (see section 7 below).[41]

Again this does not mean that the asset should be considered credit-impaired just because it is high risk. Consider an example of a bank originating a loan of €100,000 with interest of 30% per annum charged over the term of the loan, payable in monthly amortising instalments. The bank's customer has a high credit risk on origination and the bank expects a large portion of this type of customer to pay late or fail to pay some or all of their instalment payments. Although the loan is of high credit risk (which is supported by the high interest rate), none of the loss events listed above have occurred and the loan was not the result of a substantial modification and derecognition of a distressed debt. Hence, the bank should assess the loan not to be credit-impaired on origination.

> **For financial assets that are credit-impaired on purchase or origination, the accounting treatment is the same as under IAS 39.**

For financial assets that are considered to be credit-impaired on purchase or origination, the EIR is calculated taking into account the initial lifetime ECLs in the estimated cash flows.[42] This accounting treatment is the same as that under IAS 39 for similar assets.[43] It is also consistent with the original method for measuring impairment proposed in the 2009 Exposure Draft.

Consequently, no allowance is recorded for 12-month ECLs for financial assets that are credit-impaired on initial recognition. The rationale for not recording a 12-month ECL allowance for these assets is that the losses are already reflected in the fair values at which they are initially recognised. The same logic could be applied to all the other financial assets which are not credit-impaired, arguing that they, too, are initially recognised at a fair value that reflects expectations of future losses. The distinction is made because the double-counting of 12-month ECLs on initial recognition would be too large for assets with such a high credit risk since default has already occurred and the 12-month ECLs are already reflected in the initial fair value. The exclusion of initial ECLs from the computation of the EIR would lead to a distortion that would be too significant to be acceptable.

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[39] IFRS 9.5.5.3, 5.5.5, 5.5.13
[40] IFRS 9.B5.4.7
[41] IFRS 9.B5.5.26
[42] IFRS 9.B5.4.7, Appendix A, BC5.214, BC5.217
[43] IAS 39.AG5

For financial assets that were credit-impaired on purchase or origination, the credit-adjusted EIR is also used subsequently to discount the ECLs. In subsequent reporting periods an entity is required to recognise:

‣ In the statement of financial position, the cumulative changes in lifetime ECLs since initial recognition, discounted at the credit-impaired EIR (see section 4.7 below), as a loss allowance[44]

‣ In profit or loss, the amount of any change in lifetime ECLs as an impairment gain or loss. An impairment gain is recognised if favourable changes result in the lifetime ECLs estimate becoming lower than the original estimate that was incorporated in the estimated cash flows on initial recognition when calculating the credit-adjusted EIR[45]

How we see it

For favourable changes that result in lower lifetime ECLs than the original estimate on initial recognition, IFRS 9 does not provide guidance on where in the statement of financial position the debit entry should be booked. In our view, the impairment gain should be recognised as a direct adjustment to the gross carrying amount. This is supported by the application guidance in IFRS 9, for purchased or originated credit-impaired financial assets, the ECLs are included in the estimated cash flows when calculating the credit-adjusted EIR and hence, the changes in estimates of ECLs should adjust the gross carrying amount of the financial asset. An alternative treatment would be to recognise a negative loss allowance which would reflect the favourable changes in lifetime ECLs.

In calculating interest revenue for purchased or originated credit-impaired assets, the holder applies the credit-adjusted EIR to the amortised cost of these financial assets from initial recognition.

Along with the other credit risk disclosure requirements (see section 14 below), the holder is required to explain how it has determined that assets are credit-impaired (including the inputs, assumptions and estimation techniques used). It is also required to disclose the total amount of undiscounted ECLs at initial recognition for financial assets initially recognised during the reporting period that were purchased or originated credit-impaired.[46]

The accounting treatment for a purchased credit-impaired financial asset is illustrated in the following example:

Example 2: Calculation of the credit-adjusted effective interest rate and recognition of a loss allowance for a purchased credit-impaired financial asset

On 1 January 2012, Company D issued a bond that required it to pay an annual coupon of €800 in arrears and to repay the principal of €10,000 on 31 December 2021. By 2017, Company D was in significant financial difficulties and was unable to pay the coupon due on 31 December 2017. On 1 January 2018, Company V estimates that the holder could expect to receive a single payment of €4,000 at the end of 2019. It acquires the bond at an arm's length price of €3,000. Company V determines that the debt instrument is credit-impaired on initial recognition, because of evidence of significant financial difficulty of Company D and because the debt instrument was purchased at a deep discount.

It can be shown that using the contractual cash flows (including the €800 overdue) gives rise to an EIR of 70.1% (the net present value of €800 now and annually thereafter until 2021 and €10,000 receivable at the end of 2021 equals €3,000

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[44] IFRS 9.5.5.13, B5.5.45
[45] IFRS 9.5.5.14
[46] IFRS 7.35H(c)

4   Measurement of expected credit losses

The standard defines credit loss as the difference between all contractual cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive (i.e., all cash shortfalls), discounted at the original EIR (or credit-adjusted EIR for purchased or originated credit-impaired financial assets). When estimating the cash flows, an entity is required to consider:[47]

▸ All contractual terms of the financial instrument (including prepayment, extension, call and similar options) over the expected life of the financial instrument (see section 4.5 below). The maximum period to consider when measuring ECLs is the maximum contractual period (including extension options at the discretion of the borrower) over which the entity is exposed to credit risk (with an exception for revolving facilities)

▸ Cash flows from the sale of collateral held (see 4.8.2 below) or other credit enhancements that are integral to the contractual terms

Also, the standard goes on to define ECLs as 'the weighted average of credit losses with the respective risks of a default occurring as the weights'.[48]

The standard does not prescribe specific approaches to estimate ECLs, but stresses that the approach used must reflect the following:[49]

▸ An unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes (see 4.6 below)

▸ The time value of money (see 4.7 below)

▸ 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 (see 4.9 below)

> As ECLs take into account both the amount and the timing of payments, a credit loss arises even if the holder expects to receive all the contractual payments due, but at a later date.

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[47] IFRS 9 Appendix A
[48] IFRS 9 Appendix A
[49] IFRS 9.5.5.17

4.1 Definition of default

Default is not defined for the purposes of determining the risk of a default occurring. Because it is defined differently by different institutions (for instance, 30, 90 or 180 days past due), the IASB was concerned that defining 'default' could result in a definition that is inconsistent with that applied internally for credit risk management. In particular, since default is the anchor point used to measure probabilities of default and losses given default in Basel modelling, requiring a different definition would require building a different set of models for accounting purposes. Therefore, the standard requires an entity to apply a definition of default that is consistent with how it is defined for normal credit risk management practices, consistently from one period to another. It follows that an entity might have to use different default definitions for different types of financial instruments. However, the standard stresses that an entity needs to consider qualitative indicators of default when appropriate in addition to days past due, such as breaches of covenant.[50]

The IASB did not originally expect ECL calculations to vary as a result of differences in the definition of default, because of the counterbalancing interaction between the way an entity defines default and the credit losses that arise as a result of that definition of default.[51] (For instance, if an entity uses a shorter delinquency period of 30 days past due instead of 60 days past due, the associated loss given default (LGD) will be correspondingly smaller as it is to be expected that more debtors that are 30 days past due will in due course recover). However, the notion of default is fundamental to the application of the model, particularly because it affects the subset of the population that is subject to the 12-month ECL measure.[52]

> The standard restricts diversity by establishing a rebuttable presumption that default does not occur later than when a financial asset is 90 days past due.

The standard restricts diversity resulting from this effect by establishing a rebuttable presumption that default does not occur later than when a financial asset is 90 days past due. This presumption may be rebutted only if an entity has reasonable and supportable information to support an alternative default criterion.[53]

A 90 day default definition would also be consistent with that used by banks for the advanced Basel II regulatory capital calculations (with a few exceptions).

How we see it

We observe that most banks intend to align their regulatory and accounting definitions of default. This generally means aligning the number of days past due trigger to 90 days under IFRS 9, with some exceptions for certain portfolios such as mortgages for which the regulatory definition may allow longer delinquency periods. Most banks also intend to align the accounting definition of credit-impaired for transfer to stage 3 with the definition of default.

4.2 Lifetime expected credit losses

IFRS 9 defines lifetime ECLs as the ECLs that result from all possible default events over the expected life of a financial instrument (i.e. an entity needs to estimate the risk of a default occurring on the financial instrument during its expected life).[54] The expected life considered for the measurement of

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[50] IFRS 9.B5.5.37
[51] *IFRS 9.BC5.248*
[52] *IFRS 9.BC5.249*
[53] IFRS 9.B5.5.37, BC5.252
[54] IFRS 9 Appendix A, B5.5.43

lifetime ECLs cannot be longer than the maximum contractual period (including extension options at the discretion of the borrower) over which the entity is exposed to credit risk. However, there is an exception for revolving facilities (see section 11 below).

ECLs should be estimated based on the present value of all cash shortfalls over the remaining expected life of the financial asset, i.e., the difference between:[55]

- The contractual cash flows that are due to an entity under the contract
- The cash flows that the holder expects to receive

As ECLs take into account both the amount and the timing of payments, a credit loss arises even if the holder expects to receive all the contractual payments due, but at a later date.[56]

When estimating lifetime ECLs for undrawn loan commitments (see section 10 below), the provider of the commitment needs to:

- Estimate the expected portion of the loan commitment that will be drawn down over the expected life of the loan commitment. Except for revolving facilities (see section 11 below), the expected life will be capped at the maximum contractual period, including extension options at the discretion of the borrower, over which the entity is exposed to credit risk (see 4.3 below for 12-month ECLs)[57]
- Calculate the present value of cash shortfalls between the contractual cash flows that are due to the entity if the holder of the loan commitment draws down that expected portion of the loan and the cash flows that the entity expects to receive if that expected portion of the loan is drawn down[58]

For a financial guarantee contract (see section 10 below), the guarantor is required to make payments only in the event of a default by the debtor in accordance with the terms of the instrument that is guaranteed. Accordingly, the estimate of lifetime ECLs would be based on the present value of the expected payments to reimburse the holder for a credit loss that it incurs, less any amounts that the guarantor expects to receive from the holder, the debtor or any other party. If an asset is fully guaranteed, the ECL estimate for the financial guarantee contract would be the same as the present value of the estimated cash shortfall for the asset subject to the guarantee.[59]

4.3   12-month expected credit losses

The 12-month ECLs is defined as a portion of the lifetime ECLs that represent the ECLs that result from default events on a financial instrument that are possible within the 12 months after the reporting date.[60] The standard explains further that the 12-month ECLs are a portion of the lifetime ECLs that will result if a default occurs in the 12 months after the reporting date (or a shorter period if the expected life of a financial instrument is less than 12 months), weighted by the probability of that default occurring.[61]

Because the calculation is based on the probability of default (PD), the standard emphasises that the 12-month ECL is not the lifetime ECL that an entity will incur on financial instruments that it predicts will default in the next 12 months (i.e., for which the PD over the next 12 months is greater than 50%). For instance, the PD might be only 5%, in which case, this should be used to

> 12-month ECLs are the portion of the lifetime ECLs that results from default events that are possible within the next 12 months, weighted by the probability of that default ocurring.

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[55] IFRS 9.B5.5.29
[56] IFRS 9.B5.5.28
[57] IFRS 9.B5.5.31
[58] IFRS 9.B5.5.30
[59] *IFRS 9.B5.5.32*
[60] IFRS 9 Appendix A
[61] IFRS 9.B5.5.43

calculate 12-month ECLs, even though it is not probable that the asset will default. Also, the 12-month ECLs are not the cash shortfalls that are predicted over only the next 12 months. For an asset defaulting in the next 12 months, the lifetime ECLs that need to be included in the calculation will normally be significantly greater than just the cash flows that were contractually due in the next 12 months.

If the financial instrument has a maturity of less than 12 months then the 12-month ECLs are the credit losses expected over the period to maturity.

For undrawn loan commitments (see section 10 below), an entity's estimate of 12-month ECLs should be based on its expectations of the portion of the loan commitment that will be drawn down within 12 months of the reporting date.[62]

As already mentioned at section 1.2 above, the IASB believes that the 12-month ECLs serve as a proxy for the recognition of initial ECLs over time, as proposed in the 2009 Exposure Draft, and they mitigate the systematic overstatement of interest revenue that is recognised under IAS 39.[63] This practical approximation was necessary as a result of the decision to decouple the measurement and allocation of initial ECLs from the determination of the EIR following the re-deliberations of the 2009 Exposure Draft.[64]

How we see it

The stage 1, 12-month allowance overstates the necessary allowance for each financial instrument after initial recognition. However, this is offset by the fact that the allowance is not further increased (except for changes in the 12-month ECLs) until the instrument's credit risk has significantly increased and it is transferred to stage 2. For a portfolio of instruments, with various origination dates, the overall provision may (very approximately) be a similar size as might be achieved using a more conceptually robust approach. Although there is no conceptual justification for an allowance based on 12-month ECLs, it was designed to be a pragmatic solution to achieve an appropriate balance between faithfully representing the underlying economics of a transaction and the cost of implementation.

How accurate a proxy the 12-month and lifetime ECL model is for a more conceptually pure approach will depend on the nature of the portfolio. Also, the effect of recording a 12-month ECL in the first reporting period that a financial instrument is recognised will not have a significant effect on reported income if the portfolio is stable in size from one period to the next. The 12-month ECL allowance may, however, significantly reduce the reported income for entities which are expanding the size of their portfolio.

Although the choice of 12 months is arbitrary, it is the same time horizon as used for the more advanced bank regulatory capital calculation under the Basel framework.[65] The definition in IFRS 9 of 12-month ECLs is similar to the Basel Committee's definition of ECL, although the modelling requirements differ significantly.[66] The 12-month requirement under IFRS 9 will always differ

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[62] IFRS 9.B5.5.31
[63] IFRS 9.BC5.135
[64] IFRS 9.BC5.199
[65] Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards, June 2006 and Basel III:A global regulatory framework for more resilient banks and banking systems*, June 2011.
[66] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012.

from that computed for regulatory capital purposes, as the IFRS 9 measure is a point-in-time estimate, reflecting currently forecast economic conditions, while the Basel regulatory figure is based on through-the-cycle assumptions of default and conservative estimates of losses given default. However, banks that use an advanced approach to calculate their capital requirements should be able to use their existing systems and methodologies as a starting point and make the necessary adjustments to flex the calculation to comply with IFRS 9.

As mentioned above, the 12-month ECLs are defined as a portion of the lifetime ECLs that represent the ECLs that result from default events on a financial instrument that are possible within the 12-months after the reporting date.[67] When measuring 12-month ECLs, one question is whether the cash shortfalls used should take into account only default events within the next 12 months or subsequent default events as well. The issue arises for instruments that are expected to default and cure (i.e., to restore to performing) and then default again after curing.

IFRS 9 does not explicitly mention the treatment of cures and subsequent defaults when calculating ECLs. However, the ITG briefly talked about this in its discussion about the life of revolving credit card portfolios in April 2015: 'As regards assets in Stage 2, it was acknowledged that the probability of assets defaulting and curing would have to be taken into account and that it would be necessary to build this into any models dealing with expected credit loss calculations. However, it was noted that materiality would need to be considered.'[68]

How we see it

We conclude from the ITG discussion that cure events should only be reflected in the calculation of the LGD to the extent that they are expected to be effective. Consequently, if it is predicted that the asset will re-default in subsequent years, this need not be included in the calculation of 12-month expected losses if the defaults are expected to be unrelated to the first default. In practice, however, IFRS 9 acknowledges that a variety of techniques can be used to meet the objective of ECL and that the definition of default may vary, by product, across a bank and between banks.[69]

When measuring ECLs, the treatment of re-defaults affects both the PD and the LGD. Therefore, the same treatment should be applied consistently to determine both the PD and the LGD.

4.4   Probability of default (PD) and loss rate approaches

As mentioned above, the standard does not prescribe specific approaches to estimate ECLs. Some of the common approaches include the PD and loss rate approaches (see sections 4.4.1 and 4.4.2, respectively).

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[67] *IFRS 9 Appendix A*
[68] Transition Resource Group for Impairment of Financial Instruments, Meeting Summary, *Paragraph* 42(b), 22 April 2015.
[69] IFRS 9.B5.5.37, BC5.252, BC5.265

4.4.1 Probability of default (PD) approach

Calculations of the 12-month and lifetime ECLs are illustrated below:

Example 3: 12-month and lifetime expected credit loss measurement based on a PD approach

On 31 December 2016, Bank A originates a 10 year loan with a gross carrying amount of $1,000,000, with interest being due at the end of each year and the principal due at maturity. In line with IFRS 9, Bank A must recognise an impairment allowance for the ECLs, considering current and forward looking credit risk information.

The ECLs are a probability-weighted estimate of the present value of estimated cash shortfalls, i.e. the weighted average of credit losses, with the respective risks of a default occurring used as the weights. For this purpose, the following parameters must be estimated:

▸ Probability of Default (PD) - Estimate of the likelihood of default over a given time horizon (e.g., from t_{i-1} to t_i). A default may only happen at a t_i horizon if the facility has not been previously derecognised and is still in the portfolio. An early exit (EE may occur in case of default unless the facility reverts to performing without significant modification of the contractual terms. The marginal probability of default for the period t_{i-1} to t_i is then adjusted from the probability that an early exit occurred during the previous periods:

$$PD_{t_i} \times \prod_{j=1}^{j=i-1}(1 - EE_{t_j})$$

We note that, for simplicity, Bank A may decide to model EE within the PD component.

▸ Loss Given Default (LGD) - Estimate of the loss arising in case a default occurs at a given time (e.g., t_i). It is based on the difference between the contractual cash flows due and those that the lender would expect to receive, including from the realization of any collateral. It is usually expressed as a percentage of the EAD.

▸ Exposure at Default (EAD) - Estimate of the exposure at a future default date, taking into account expected changes in the exposure after the reporting date, including repayments of principal and interest, whether scheduled by contract or otherwise, expected drawdowns on committed facilities, and accrued interest from missed payments.

▸ Discount Rate (r) - Rate used to discount an expected loss to a present value at the reporting date.

Based on these parameters, an ECL can be computed for any horizon - typically for each due date of an exposure. The computation formula can be expressed, as follows:

$$ECL_{t_n} = \sum_{t_i=t_1}^{t_i=t_n} \frac{PD_{t_i} \times \prod_{j=1}^{j=i-1}(1\text{-}EE_{t_j}) \times LGD_{t_i} \times EAD_{t_i}}{(1 + r_i)^{t_i}}$$

Where:

i   = each future payment

t_i = maturity of the payment i

t_n = horizon considered (either 12-month or lifetime)

Example 3: 12-month and lifetime expected credit loss measurement based on a PD approach (cont'd)

Stage 1: 12-month ECLs of $422

At origination, the loan is in stage 1. Thus a corresponding 12-month ECL allowance is recognised, i.e. the portion of the lifetime ECLs that result from default events that are possible within 12 months after the reporting date.

Based on statistical and qualitative information, Bank A has computed the following ECL parameters at origination.

As interest is paid on a yearly basis, ECLs are calculated using annual periods.

Each year, EAD equals the outstanding principal plus accrued interest due at the end of the year. This loan does not allow any prepayment, therefore the EAD is constant. The effective interest rate of the loan is assumed to be the contractual rate, which is 3%.

Bank A sets $EE = PD_{n-1} \times 0.8$, on the basis that a proportion of the loans which default are expected to cure and will once again be at risk of default.

Based on provided guarantees and collateral, LGD is estimated at 25% of EAD, whatever the date of default.

Year	EAD	Discount rate	Cumulative PD @ origination	Marginal PD	Cumulative EE_{t-1} @ origination	LGD	Marginal ECL	
2016	1,000,000							
2017	1,030,000	3%	0.17%	0.17%	0.00%	25%	$422	12m ECL
2018	1,030,000	3%	0.49%	0.32%	0.14%	25%	$775	
2019	1,030,000	3%	0.86%	0.37%	0.39%	25%	$877	
2020	1,030,000	3%	1.38%	0.53%	0.69%	25%	$1,196	
2021	1,030,000	3%	1.84%	0.47%	1.11%	25%	$1,027	
2022	1,030,000	3%	2.37%	0.54%	1.47%	25%	$1,141	
2023	1,030,000	3%	2.85%	0.49%	1.90%	25%	$1,014	
2024	1,030,000	3%	3.30%	0.46%	2.28%	25%	$912	
2025	1,030,000	3%	3.84%	0.56%	2.64%	25%	$1,073	
2026	1,030,000	3%	4.50%	0.69%	3.07%	25%	$1,280	
							$9,718	Lifetime ECL

$$\text{Marginal PD}_i = 1 - \frac{1 - \text{Cum PD}_i}{1 - \text{Cum PD}_{i-1}}$$

$$\text{Marginal ECL}_i = \frac{\text{PD}_i \times (1 - \text{Cum EE}_{i-1}) \times \text{LGD}_i \times \text{EAD}_i}{(1 + r_i)^i}$$

Stage 2: lifetime ELCs of $50,285

On 31 December 2019 – 3 years after origination, the loan shows signs of significant deterioration in credit quality based on the creditworthiness of the obligor and forward looking information, and Bank A moves it to stage 2. Example 10 below shows the calculation underlying this assessment.

Consistent with the significant increase in credit risk, the PD of the obligor has increased. In consequence, the probability of an early exist has also increased, because of the higher level of default. For the purposes of this example, we assume that there are no significant fluctuations in collateral values and the LGD remains constant.

Example 3: 12-month and lifetime expected credit loss measurement based on a PD approach (cont'd)

Year	EAD	Discount rate	Cumulative PD	Marginal PD	Cumulative EE_{t-1}	LGD	Marginal ECL	
2019	1,000,000		0.00%					
2020	1,030,000	3%	1.40%	1.40%	0.00%	25%	$3,495	12m ECL
2021	1,030,000	3%	3.87%	2.51%	1.12%	25%	$6,017	
2022	1,030,000	3%	8.82%	5.15%	3.10%	25%	$11,756	
2023	1,030,000	3%	12.84%	4.40%	7.06%	25%	$9,366	
2024	1,030,000	3%	16.04%	3.67%	10.27%	25%	$7,322	
2025	1,030,000	3%	18.98%	3.50%	12.83%	25%	$6,585	
2026	1,030,000	3%	21.60%	3.23%	15.18%	25%	$5,745	
							$50,285	Life time ECL

Stage 3: lifetime ECLs of $262,850

In the following year, on 31 December 2020, the obligor does not pay the amount due. Based on credit information available, it is already considered to be in default and is moved to stage 3 – credit-impaired. At this time, the exposure is $1,030,000. Once a facility becomes credit-impaired, impairment must still represent ECLs. Therefore, it must be probability-based. At the reporting date, Bank A updates the appraisal value of the collateral and considers three probable scenarios:

▸ **Scenario 1** – Cure: the obligor eventually pays past dues and the loan reverts to performing. In this case, ECL corresponds to lifetime losses expected from loans that have recently defaulted. Based on its historical data and using the methodology described above, Bank A expects an ECL of $130,000.

▸ **Scenario 2** – Restructure: Bank A comes to a restructuring agreement with the obligor. After 6 months of negotiation, the loan is written off and a new loan is initiated with a net present value of $800,000.

▸ **Scenario 3** – Liquidation: The loan is written off and the bank starts the collection of the contractual collateral. Bank A expects to sell the collateral within a year and to collect $700,000 net of recovery costs.

The ECL of each scenario can be calculated, as follows:

$$\text{ECL} = \text{EAD} - \sum_{t_i = t_1}^{t_i = t_n} \frac{\text{CF}_{t_i} - \text{RC}_{t_i}}{(1 + r_i)^{t_i}}$$

Where:

CF	= expected future cash flows
RC	= expected recovery costs

Probable scenarios	Prob-ability	EAD	Disc-count rate	Expected net future cash flows	Expected recovery time	ECL of each scenario	Weighted ECL
Scenario 1: Cure	20%	1,030,000	3%	900,000	0.0	$130,000	$26,000
Scenario 2: Restructure	40%	1,030,000	3%	800,000	0.5	$241,737	$96,695
Scenario 3: Liquidation	40%	1,030,000	3%	700,000	1.0	$350,388	$140,155
						Weighted average ECL	$262,850
						% of EAD:	26%

$$ECL = EAD - \frac{\text{Exp. net future CF}}{(1+r)^{\text{exp recovery time}}}$$

How we see it

Our observation of emerging practices suggests that most sophisticated banks intend to develop their IFRS 9 solutions by adjusting and extending their existing Basel models. This is true for all types of component models: PD, LGD and EAD. This is perhaps unsurprising given the historical investment large banks have made in their Basel models, and the fact that IFRS 9 shares fundamental similarities in expected loss modelling. But, for many banks, creating lifetime estimates and altering models to satisfy the complex and detailed IFRS 9 requirements will still require significant work.

4.4.2 Loss rate approach

Not every entity calculates a separate risk of a default occurring and an LGD, but instead some use a loss rate approach. Using this approach, the entity develops loss-rate statistics on the basis of the amount written off over the life of the financial assets. It must then adjust these historical credit loss trends for current conditions and expectations about the future. The following Illustrative Example 9 from IFRS 9 is designed to illustrate how an entity measures 12-month ECLs using a loss rate approach:[70]

Example 4: 12-month expected credit losses measurement based on a loss rate approach

Bank A originates 2,000 loans with a total gross carrying amount of $500,000. Bank A segments its portfolio into borrower groups (Groups X and Y) on the basis of shared credit risk characteristics at initial recognition. Group X comprises 1,000 loans with a gross carrying amount per client of $200, for a total gross carrying amount of $200,000. Group Y comprises 1,000 loans with a gross carrying amount per client of $300, for a total gross carrying amount of $300,000. There are no transaction costs and the loan contracts include no options (for example, prepayment or call options), premiums or discounts, points paid, or other fees.

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[70] IFRS 9 IG Example 9, IE53-IE57

Bank A measures ECLs on the basis of a loss rate approach for Groups X and Y. In order to develop its loss rates, Bank A considers samples of its own historical default and loss experience for those types of loans. In addition, Bank A considers forward-looking information, and updates its historical information for current economic conditions as well as reasonable and supportable forecasts of future economic conditions. Historically, for a population of 1,000 loans in each group, Group X's loss rates are 0.3 per cent, based on four defaults, and historical loss rates for Group Y are 0.15 per cent, based on two defaults.

Group	Number of clients in sample	Estimated per client gross carrying amount at default	Total estimated gross carrying amount at default	Historic per annum average defaults	Estimated total gross carrying amount at default	Present value of observed loss (a)	Loss rate
	A	B	C = A × B	D	E = B × D	F	G = F ÷ C
X	1,000	$200	$200,000	4	$800	$600	0.3%
Y	1,000	$300	$300,000	2	$600	$450	0.15%

(a) ECLs should be discounted using the EIR. However, for the purposes of this example, the present value of the observed loss is assumed.[71]

At the reporting date, Bank A expects an increase in defaults over the next 12 months compared to the historical rate. As a result, Bank A estimates five defaults in the next 12 months for loans in Group X and three for loans in Group Y. It estimates that the present value of the observed credit loss per client will remain consistent with the historical loss per client.

On the basis of the expected life of the loans, Bank A determines that the expected increase in defaults does not represent a significant increase in credit risk since initial recognition for the portfolios. On the basis of its forecasts, Bank A measures the loss allowance at an amount equal to 12-month ECLs on the 1,000 loans in each group amounting to $750 and $675 respectively. This equates to a loss rate in the first year of 0.375 per cent for Group X and 0.225 per cent for Group Y.

Group	Number of clients in sample	Estimated per client gross carrying amount at default	Total estimated gross carrying amount at default	Expected defaults	Estimated total gross carrying amount at default	Present value of observed loss	Loss rate
	A	B	C = A × B	D	E = B × D	F	G = F ÷ C
X	1,000	$200	$200,000	5	$1,000	$750	0.375%
Y	1,000	$300	$300,000	3	$900	$675	0.225%

Bank A uses the loss rates of 0.375 per cent and 0.225 per cent respectively to estimate 12-month ECLs on new loans in Group X and Group Y originated during the year and for which credit risk has not increased significantly since initial recognition.

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[71] IFRS 9.5.5.17(b)

The example above illustrates that under the loss rate approach, an entity would compute its loss rates by segmenting its portfolio into appropriate groupings (or sub-portfolios) based on shared credit risk characteristics and then updating its historical loss information with more forward-looking information. The loss rate was derived simply by computing the ratio between the present value of observed losses (the numerator) and the gross carrying amount of the loans (the denominator).

How we see it

Although the loss rate approach does not require an explicit risk of a default occurring, there has to be an estimate of the number of defaults in order to determine whether there has been a significant increase in credit risk (see 5.5 below). Hence, IFRS 9 will require any entities that intend to use this approach to track the likelihood of default.

ECLs must be discounted at the EIR. However, in this example, the present value of the observed loss is assumed. This is an additional area of complexity that entities have to take into account when trying to build upon their existing loss rate approaches.

4.5 Expected life versus contractual period

Lifetime ECLs are defined as the ECLs that result from all possible default events over the expected life of a financial instrument.[72] This is consistent with the requirement that an entity should assess whether the credit risk on a financial instrument has increased significantly since initial recognition by using the change in the risk of a default occurring over the expected life of the financial instrument.[73]

> When measuring ECLs, entities must consider the maximum contractual period over which the entity is exposed to credit risk.

An entity must, therefore, estimate cash flows and the instrument's life by considering all contractual terms of the financial instrument (for example, prepayment, extension, call and similar options). There is a presumption that the expected life of a financial instrument can be estimated reliably. In those rare cases when it is not possible to reliably estimate the expected life of a financial instrument, the entity must use the remaining contractual term of the financial instrument.[74]

However, the maximum period to consider when measuring ECLs must be the maximum contractual period (including extension options) over which the entity is exposed to credit risk and not a longer period, even if that longer period is consistent with business practice.[75] Although an exception to this principle has been added for revolving facilities (see section 11 below), the IASB remains of the view that the contractual period over which an entity is committed to provide credit (or a shorter period considering prepayments) is the correct conceptual outcome. The IASB noted that most loan commitments will expire at a specified date, and if an entity decides to renew, or extend, its commitment to extend credit, it will be a new instrument for which the entity has the opportunity to revise the terms and conditions.[76]

This means that extension options must only be reflected in the measurement of ECLs as long as this does not extend the horizon beyond the maximum contractual period over which the entity is exposed to credit risk. Extension options at the discretion of the lender must, therefore, be excluded from the

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[72] IFRS 9 Appendix A
[73] IFRS 9.5.5.9
[74] IFRS 9 Appendix A, B5.5.51
[75] IFRS 9.5.5.19
[76] IFRS 9.BC5.260

measurement of ECLs. Similarly, a lender's ability to require prepayment limits the horizon over which it is exposed to credit risk. The first prepayment date at the discretion of the lender should, therefore, represent the maximum period to be reflected in the expected loss calculation.

When assessing the impact of extension options at the discretion of the borrower, an entity should estimate both the probability of exercise of the extension option as well as the portion of the loan that will be extended (if the extension option can be exercised for a portion of the loan only). This is consistent with how lifetime expected losses must be assessed for loan commitments where an entity's estimate of ECLs must be consistent with its expectations of drawdowns on that loan commitment. Although the standard is not explicit on this point, the effect of extension options would be best modelled not by estimating an average life of the facility, but by estimating the EAD each year over the maximum lifetime. This is because use of an average life would not reflect losses expected to occur beyond the average life.[77]

Expected prepayments at the discretion of borrowers should also be reflected in the measurement of ECLs. As with extension options, an entity must estimate both the probability of exercise of the prepayment option as well as the portion of the loan that will be prepaid (if the prepayment option can be exercised for a portion of the loan only). As with extension options, the standard does not specify whether prepayment patterns should be reflected through an amortising EAD over the maximum contractual period of the financial instruments or, rather, by shortening the horizon over which to measure ECLs to the average life of the financial instruments.

How we see it

Similar to the treatment of extension options, described above, in our view, it is more appropriate to adjust the EAD for the facility each year over the maximum lifetime. We consider this a more transparent way of incorporating product features and potential impacts of different macroeconomic scenarios that can, for example, affect prepayment patterns and customers' ability to refinance.

Further complexity in assessing expected prepayments and extensions arises if one considers that the behaviour of borrowers is affected by their creditworthiness. This means that prepayment and extension patterns should probably be estimated separately for stage 1 and stage 2 assets. This may represent a significant challenge, as making such estimates would require distinct historical observations for each of the stage 1 and 2 populations, which are unlikely to be available given that these populations were never identified in the past. Prepayment assumptions for stage 2 assets would need to factor in the probabilities that some may subsequently default and some may cure. A further complication is that expected prepayment and extension behaviour may vary with changes in the macroeconomic outlook.

The standard is clear that, for loan commitments and financial guarantee contracts, the time horizon to measure ECLs is the maximum contractual period over which an entity has a present contractual obligation to extend credit.[78] However, for certain revolving credit facilities (e.g., credit cards and overdrafts), as an exception to the normal rule, this period is extended beyond the maximum contractual period and includes the period over which the entity is exposed to credit risk and ECLs would not be mitigated by credit

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[77] IFRS 9.B.5.5.31
[78] IFRS 9.B5.5.38

risk management actions (see section 11 below). This exception is limited to facilities that include both a loan and an undrawn commitment component, that do not have a fixed term or repayment structure and usually have a short contractual cancellation period (for example, one day.)[79]

At its April 2015 meeting, the ITG discussed, how to determine the maximum period for measuring ECLs, by reference to the following example:[80]

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Example 5: Determining the maximum contractual period when measuring expected credit losses

Bank A manages a portfolio of variable rate mortgages on a collective basis. The mortgage loans are issued to retail customers in Country X with the following terms:

▸   the stated maturity is 6 months with an automatic extension feature whereby, unless the borrower or lender take action to terminate the loan at the stated maturity date, the loan automatically extends for the following 6 months;

▸   the interest rate is fixed for each 6-month period at the beginning of the period. The interest rate is reset to the current market interest rate on the extension date; and

▸   the lender's right to refuse an extension is unrestricted.

It is assumed that the mortgage loans meet the criteria for amortised cost measurement under paragraph 4.1.2 of IFRS 9.

In practice, borrowers are generally expected not to elect to terminate their loans on the stated maturity date, because moving the mortgage to another bank, or applying for a new product, generally involves an administrative burden and has little or no economic benefit for the borrower.

Furthermore, Bank A does not complete regular credit file reviews for individual loans and as a result does not usually cancel the loans unless it receives information about an adverse credit event in respect of a particular borrower. On the basis of historical evidence, such loans extend many times and can last for up to 30 years.

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The ITG noted that:

▸   IFRS 9 is clear that the maximum period to consider when measuring ECLs in this example would be restricted to 6 months, because this is the maximum contractual period over which the lender is exposed to credit risk, i.e., the period until the lender can next object to an extension.[81]

▸   The standard requires that extension options must be considered when determining the maximum contractual period, but does not specify whether these are lender or borrower extension options. However, if the extension option is within the control of the lender, the lender cannot be forced to continue extending credit. Therefore, such an option cannot be considered as lengthening the maximum period of exposure to credit risk. Conversely, if a borrower holds an extension option that could force the lender to continue extending credit, this would have the effect of lengthening that maximum contractual period of credit exposure.

▸   The maximum contractual period over which the entity is exposed to credit risk should be determined in accordance with the substantive contractual terms of the financial instrument. To further illustrate this point, a situation in which a lender is legally prevented from exercising a contractual right should be seen as distinct from a situation in which a lender chooses not to exercise a contractual right for practical or operational reasons.

Options for the lender to extend the period of credit would not be considered in measuring ECLs.

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[79] IFRS 9.5.5.20, B5.5.39, B5.5.40

[80] Transition Resource Group for Impairment of Financial Instruments, Agenda ref 1, *The maximum period to consider when measuring expected credit losses,* 22 April 2015.

[81] IFRS 9.B5.5.19

▸ In the example presented, the facility is not of a revolving nature and the borrower does not have any such flexibility regarding drawdowns. Consequently, it would not be appropriate to analogies the 6-month mortgage loan to a revolving credit facility that has been fully drawn at the reporting date. Hence, the example falls outside the narrow scope exception for revolving credit facilities (e.g., credit cards and overdraft facilities) in which the maximum period to consider when measuring ECLs is over the period that the entity is exposed to credit risk and ECLs would not be mitigated by credit risk management actions, even if that period extends beyond the maximum contractual period (section 11 below).[82]

▸ Consequently, it was acknowledged that there may be a disconnect between the accounting and credit risk management view in some situations (e.g. an entity may choose to continue extending credit to a long-standing customer despite being in a position to reduce or remove the exposure). See further discussion on the application of the revolving credit facilities exception to multi-purpose facilities (at section 11 below).

For demand deposits that have no fixed maturity and can be withdrawn by the holder on very short notice (e.g., one day) (assuming there is no contractual or legal constraint that could prevent the holder from withdrawing its cash at any time), the period used by the holder of such demand deposits to estimate ECLs would be limited to the contractual notice period, i.e., one day. This is the maximum contractual period over which the holder is exposed to credit risk. In accordance with paragraph 5.5.19 of IFRS 9, extension periods at the option of the holder are excluded in estimating the maximum contractual period because the holder can unilaterally choose not to extend credit and thus can limit the period over which it is exposed to credit risk. Furthermore, demand deposits do not fall under the revolving credit facility exception (see section 11 below) as they do not comprise an undrawn element.[83]

4.6   Probability-weighted outcome and multiple scenarios

ECLs must reflect an unbiased and probability-weighted estimate of credit losses over the expected life of the financial instrument (i.e. the weighted average of credit losses with the respective risks of a default occurring as the weights).[84]

The standard makes it clear that when measuring ECLs, in order to derive an unbiased and probability-weighted amount, an entity needs to evaluate a range of possible outcomes.[85] This involves identifying possible scenarios that specify:

a)   The amount and timing of the cash flows for particular outcomes

b)   The estimated probability of these outcomes

Although an entity does not need to identify every possible scenario, it will need to take into account the possibility that a credit loss occurs, no matter how low that probability is.[86] This is not the same as a single estimate of the worst-case or best-case scenario, or the most likely outcome (i.e., when there is a low risk or probability of a default (PD) with high loss outcomes, the most likely outcome could be no credit loss, even though an allowance would be required based on probability-weighted cash flows).[87] It is worthwhile noting that it is implicit that the sum of the weighted probabilities will be equal to one. A simple example of application of a probability-weighted calculation is shown in Example 6.

> ECLs are a probability-weighted estimate of credit losses over the expected life of the financial instrument.

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[82] IFRS 9.B5.5.20
[83] IFRS 9.5.5.20
[84] IFRS 9.5.5.17(a), Appendix A, B5.5.28
[85] IFRS 9.5.5.17(a)
[86] IFRS 9.5.5.18
[87] IFRS 9.B5.5.41

Without taking into account multiple economic scenarios (see below) calculating a probability-weighted amount may not require a complex analysis or a detailed simulation of a large number of scenarios and the standard suggests that relatively simple modelling may be sufficient. For instance, the average credit losses of a large group of financial instruments with shared risk characteristics may be a reasonable estimate of the probability-weighted amount. In other situations, the identification of scenarios that specify the amount and timing of the cash flows for particular outcomes and the estimated probability of those outcomes will probably be needed. In those situations, the ECLs shall reflect at least two outcomes in accordance with paragraph 5.5.18 of IFRS 9.[88]

At the December 2015 ITG meeting, the question was asked as to whether the use of multiple scenarios referred to in the standard relates only to what might happen to particular assets given a single forward-looking economic scenario (i.e. default or no default), or whether application of the standard requires an entity to use multiple forward-looking economic scenarios, and if so how.

> Multiple macroeconomic scenarios always need to be consdered as the effect of non-linearity will often be material.

The ITG members noted that the measurement of ECLs is required to reflect an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes. Consequently, when there is a non-linear relationship between the different forward-looking scenarios and their associated credit losses, using a single forward-looking economic scenario would not meet this objective. In such cases, more than one forward-looking economic scenario would need to be used in the measurement of ECLs.[89] For each scenario the associated ECLs would need to be multiplied by the weighting allocated to that scenario.

The ITG also discussed the use of multiple economic scenarios to assess whether exposures should be measured using lifetime economic losses (see section 5.7 below). It was noted by the ITG that if the same variable is relevant for determining significant increase in credit risk and for measuring ECLs, the same forward-looking scenarios must be used for both.

The ITG discussed a particular example in which there are considered to be three possible economic scenarios:[90]

Example 6: Incorporating single versus multiple forward-looking scenarios when measuring expected credit losses

Scenario	Future unemployment	Likelihood of occurrence	ECLs
(a)	4%	20%	£30
(b)	5%	50%	£70
(c)	6%	30%	£170

Use of a single central economic scenario based on the most likely outcome of 5 per cent unemployment, i.e. scenario (b), would give rise to an ECL of £70. However, using a probability-weighted range of scenarios, the ECL would be £92 ((£30 × 0.2) + (£70 × 0.5) + (£170 × 0.3)). Consequently, the ITG observed that in this example, using a single central forward-looking economic scenario would not result in an unbiased and probability-weighted amount in accordance with the standard.

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[88] IFRS 9.B5.5.42

[89] IASB Transition Resource Group for Impairment of Financial Instruments, Meeting Summary, Paragraph 49, 11 December 2015.

[90] IASB Transition Resource Group for Impairment of Financial Instruments, Meeting Summary, Paragraphs 50 and 51, 11 December 2015.

The ITG were concerned about the distribution of possible losses often being 'non-linear', in that the increase in losses associated with those economic scenarios that are worse than the central forecast will be greater than the reduction in losses associated with those scenarios that are more benign. To use statistical terminology, the distribution is skewed. Depending on how it is calculated, a single scenario gives the mode of this distribution (i.e., the most likely outcome) or the median (the central forecast). In contrast, the standard requires the use of the mean (i.e., a probability-weighted estimation). A possible distribution of the losses in the portfolio consistent with the above example is shown in Figure 4 below.

Figure 4: Distribution of losses
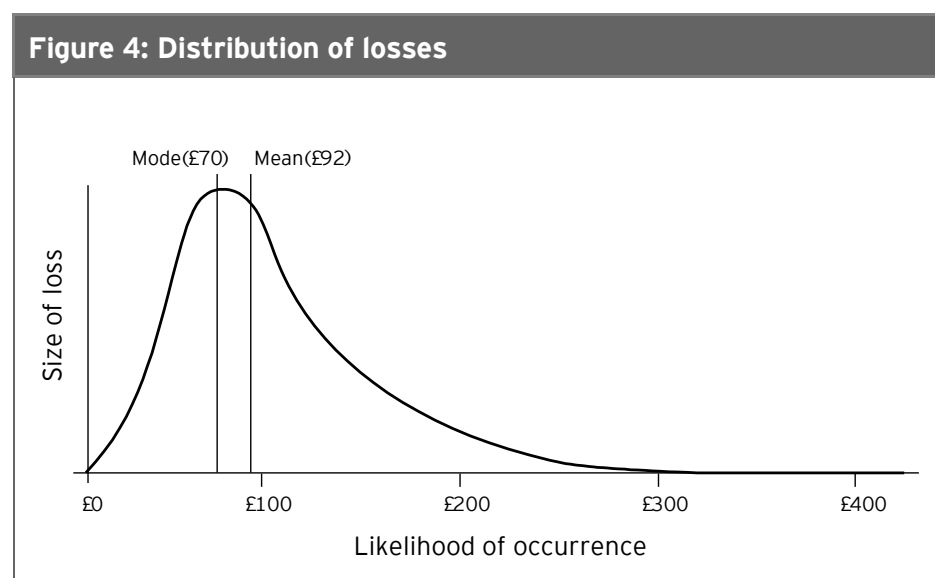
At the ITG meeting, it was noted that there are a number of possible approaches that might be used to incorporate multiple economic approaches. IFRS 9 does not prescribe any particular method of measuring ECLs and the measurement should reflect an entity's own view. What the standard does require is that the expected losses must reflect:

(a) An unbiased and probability-weighted amount that is determined using a range of possible outcomes

(b) Reasonable and supportable information that is available without undue cost or effort at the reporting date

With respect to reasonable and supportable information, ITG members made the following observations:

(a) Although IFRS 9 does not specifically require an entity to consider external information, an entity should consider information from a variety of sources in order to ensure that the information used is reasonable and supportable

(b) The information considered could vary depending on the facts and circumstances including the level of sophistication of the entity, geographical region and the particular features of the portfolio

(c) While entities are not expected to consider every possible scenario, the scenarios considered should reflect a representative sample of possible outcomes[91]

ITG members recognised that materiality considerations would need to be taken into account.

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[91] IASB Transition Resource Group for Impairment of Financial Instruments, Meeting Summary, Paragraphs 53, 11 December 2015.

In an IASB webcast on 25 July 2016, it was noted that, having considered:

(a) Whether the effect of non-linearity is material

(b) Whether the entity has a reasonable and supportable basis for this multiple scenario analysis

(c) Whether the application is possible without undue cost or effort

A conclusion may sometimes be reached that it is not necessary to actually use multiple scenarios to apply the impairment requirements in IFRS 9. However, multiple scenarios must always be considered.

At the December 2015 ITG meeting, the ITG also noted that consideration should be given to the consistency of forward-looking information used for the measurement of ECLs and for other purposes within the organisation, such as budgeting and forecasting. ITG members acknowledged that there might be differences, but observed that these should be understood and explainable.

ITG members also observed that the incorporation of forward-looking scenarios will require judgement. Consequently, they emphasised the importance of the IFRS 7 disclosure requirements relating to how forward-looking information has been incorporated into the determination of ECLs (see 14.4 and Example 28).[92]

How we see it

Since December 2015, banks have given significant attention to how multiple economic scenarios can be incorporated into ECL calculations. We have seen three main approaches being explored, as follows:

a) Probability weighted scenarios. This is similar to the method discussed at the ITG meeting in December 2015 and illustrated in Example 6 above. It involves establishing a number of scenarios (typically three scenarios, but we have seen varying numbers, generally between two and four), estimating the losses that would arise in those scenarios and allocating a weighting to each scenario. Unlike Example 6 above, these do not normally model economic variables such as unemployment rates in isolation – to do so, would also require complex modelling of the correlations between those variables. Instead, each scenario is normally a coherent combination of economic variables. For example, a scenario relevant to mortgage loans might include assumptions about unemployment, interest rates and house prices. This approach is transparent, but it may be difficult to assign the weightings to each scenario, requiring judgement as well as experience of the past. While selecting scenarios and respective weights, we expect banks to take into consideration the entire distribution of macroeconomic scenarios and select points (i.e. scenarios) from that distribution, with their respective weights representing the area of the distribution represented by the scenario. We would expect that the mean of the selected scenarios and weights is similar to that of the entire distribution.

b) The second approach is to calculate ECLs based on a central forward-looking scenario and to adjust the outcome where necessary by a factor to reflect the non-linearity of the loss distribution. In practice, it may be that a method similar to (a) above will need to be used in order to calculate this factor – so that it is not a very different approach. However, some banks view the merits of this approach as being less mechanistic and allowing more room for judgement.

92 IASB Transition Resource Group for Impairment of Financial Instruments, Meeting Summary, Paragraphs 56, 11 December 2015.

c) Monte Carlo simulation. This method seeks to calculate the expected losses associated with the entire distribution of possible scenarios, around the bank's central economic forecast. It has the advantage that it does not require the bank to formulate specific scenarios or assign weightings to them, but the simulation is dependent on assumptions that may not be transparent to either users or preparers, so that this solution can seem a 'black box'. It is also very demanding as to the volume of data that has to be manipulated and it is not how most banks manage credit risk today. This method is rarely applied in practice.

The effect of multiple scenarios will affect not just the probability of default, but also the losses given default. For instance, for property-based lending, it will be necessary to forecast the value of collateral associated with each economic scenario that is modelled. A consequence of this is that there may be a need to record an ECL allowance for an asset that, based on the central forecast of future collateral values, is fully collateralised. (Also, as a result, the loss allowance for a stage 3 asset may be higher than for an impaired asset under IAS 39).

The use of multiple scenarios may also have an effect on the estimated EAD.

How we see it

A number of other observations can be made about the use of multiple scenarios.

a) Whatever approach is used to calculate the effect of non-linearity, it will be necessary for banks to communicate the result of the calculation in a manner which can be understood by readers of the financial statements. One possible approach would be for banks to report the losses associated with the central forecast and then, separately, the effect of the consideration of other scenarios (see Example 28). This would allow banks to communicate the amounts they expect to lose and would permit comparison between banks of the effect of the adjustment for non-linearity, even if the banks use different methods to make the calculation.

b) It would seem that the effects of non-linearity depend on the countries in which banks operate and the economic characteristics of those countries. For instance, the effect of alternative scenarios of interest rates and unemployment may be greater in countries where there is more of a 'boom and bust' economic cycle. The size of the effect is also dependent on origination practices and the particular lending products – variable rate loans being more sensitive to interest rates than fixed-rate ones, while defaults on credit cards are more affected by unemployment rates. In some cases, the issue is seen as most relevant for exposures to a particular economic variable, an example being lending to companies involved in the oil industry. In this example, banks might model a number of scenarios as to how oil prices could evolve. A similar approach may be relevant for non-banks with similar exposures through long-term construction contracts or leasing activities. There is also more likely to be non-linearity in the calculation of ECLs when exposures are collateralised by assets whose values also change in response to the economic conditions that drive the probability of default. An example is residential mortgage loans.

c) It should be stressed that the ITG discussion highlighted the importance of calculating the effect of non-linearity using only reasonable and supportable information, implying that if the information is not available, then there is a limit to what can be done. However, banks will also need to take into account their regulators' expectations (see sections 1.6 and 6.1 for Basel Committee guidance).

The process of forecasting future economic conditions is discussed further in 4.9.3 below.

4.7　Time value of money

An entity needs to consider the time value of money when measuring ECLs, by discounting the estimated losses to the reporting date using a rate that approximates the EIR of the asset.[93] This has two components:

▸ Discounting recoveries to the date of default, hence 'a credit loss arises even if the entity expects to be paid in full but later than when contractually due'.[94]

▸ Discounting losses from the date of default to the reporting date. This is needed because the gross amortised cost of the asset is based on the contractual cash flows discounted at the EIR, and so not to discount cash flows that are now not expected to be received would overstate the loss.

It is rare that customers just fail to pay amounts when due. In most cases, default also involves payments being paid late, while default can lead to the acceleration of payment of amounts that are not contractually due until a later date. Therefore, modelling losses involves modelling the timing of payments when default occurs and different patterns of timing of recoverable cash flows, such as the time it takes to foreclose on and sell collateral and complete bankruptcy proceedings, before the ECLs can be discounted back to the reporting date.

Of these two components, the first has typically been included by banks in their calculation of the LGD (although not necessarily using the EIR). However, the second will also need to be calculated to comply with the standard.

The standard and its illustrative examples are silent on how the calculation should be made. In Illustrative Example 9, the present value of the observed loss is assumed and in Illustrative Example 8, a footnote states that, 'because the LGD represents a percentage of the present value of the gross carrying amount, this example does not illustrate the time value of money'.

One approach would be to model various scenarios as to how cash is collected once the loan has defaulted, and probability-weight the discounted cash flows of these various scenarios.

The discount rate is calculated, as follows:

▸ For a fixed-rate financial asset, entities are required to determine or approximate the EIR on the initial recognition of the financial asset, while for a floating-rate financial asset, entities are required to use the current EIR[95]

▸ For a purchased or originated credit-impaired financial asset (see 3.3 above), entities are required to discount ECLs using the credit-adjusted EIR determined on the initial recognition of the financial asset[96]

▸ For a loan commitment (see 10 below), entities are required to use the EIR of the asset that will result once the commitment is drawn down. This would give rise to a consistent rate for a credit facility that includes both a loan (i.e., a financial asset) and an undrawn commitment (i.e., a loan commitment). If the EIR of the resulting asset is not determinable, then

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[93] IFRS 9.5.5.17, B5.5.44
[94] *IFRS 9.B5.5.28*
[95] IFRS 9.B5.5.44
[96] IFRS 9.B5.5.45

entities are required to use the current risk-free rate (i.e., the discount rate that reflects the current market assessment of the time value of money). This should be adjusted for risks specific to the cash flows, but only if the cash flows have not already been adjusted for these risks, in order to avoid double counting[97]

‣ For financial guarantee contracts (see section 10 below) entities are required to use the current risk-free rate adjusted for risks specific to the cash flows, again to the extent that those cash flows have not already been adjusted for the risks[98]

‣ For lease receivables (see section 9.2 below), entities are required to discount the ECLs using the same discount rate used in the measurement of the lease receivables in accordance with IAS 17 or IFRS 16 (when applied)[99]

LGD data available from Basel models should include a discounting factor and sometimes this may be different from the rate required by IFRS 9. Furthermore, the discount rate used in Basel models only covers the period between default and subsequent recoveries. Therefore, entities will have to find ways to adjust their LGDs to reflect the discounting effect required by the standard (i.e., based on a rate that approximates the EIR and over the entire period from recoveries back to the reporting date). Given the requirement to use an approximation to the EIR, entities will need to work out how to determine a rate that is sufficiently accurate. One of the challenges entities will face is to interpret how much flexibility is afforded by the term 'approximation'.

At its meeting in December 2015, the ITG also discussed what was meant by the current EIR when an entity recognises interest revenue in each period based on the actual floating-rate applicable to that period. The ITG first noted that the definition of the EIR in IFRS 9 was carried forward essentially unchanged from the definition within IAS 39. Consequently, similarly to IAS 39, IFRS 9 does not specify whether an entity should use the current interest rate at the reporting date or the projected interest rates derived from the current yield curve as at the reporting date. There should be consistency between the rate used to recognise interest revenue, the rate used to project future cash flows (including cash shortfalls) and the rate used to discount those cash flows (see section 3 above).

How we see it

In relation to the guidance in paragraphs B5.5.47 and 48 on loan commitments when the EIR on the resulting asset is not determinable and for financial guarantee contracts, we make the following observations:

▶ Although it is not clear in the standard, any adjustment for the risks specific to the cash flows would be a reduction of the risk free rate, not an increase. This would be consistent with the approach applied to provisions in IAS 37 and as was made clear in the staff paper presented to the Board when this treatment was discussed in December 2013. For financial guarantee contracts, the reduction in the risk-free discount rate will increase the present value of the obligation to pay claims to the guarantee holder. This reflects the additional compensation that would be demanded to take on this risky obligation, in particular, to bear the risk that claims payments will be higher than the probability-weighted expected amount.

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[97] IFRS 9.B5.5.47, B5.5.48
[98] IFRS 9.B5.5.48
[99] IFRS 9.B5.5.46

4.8 Losses expected in the event of default

This section discusses how to take into account, when measuring ECLs, credit enhancements such as collateral and financial guarantees, cash flows from the sale of a defaulted loan and collection costs paid to an external debt collection agency.

4.8.1 Credit enhancements: collateral and financial guarantees

Although credit enhancements such as collateral and guarantees play only a limited role in assessing whether there has been a significant increase in credit risk (see 5.1 below), they do affect the measurement of ECLs. For example, for a mortgage loan, even if an entity determines that there has been a significant increase in credit risk on the loan since initial recognition, if the expected proceeds from the collateral (i.e., the mortgaged property) exceeds the amount loaned, then the entity may have nil ECLs, and, hence, an allowance of zero.

In measuring the ECLs and hence the expected cash shortfalls for a collateralised financial instrument, an entity should include the cash flows from the realisation of the collateral and other credit enhancements that are:[100]

▸ Part of the contractual terms

▸ Not recognised separately by the entity

As is the case in IAS 39, the standard specifies that the estimate of cash flows from collateral should include the effect of a foreclosure, regardless of whether foreclosure is probable, and the resulting cash flows from foreclosure on the collateral less the costs of obtaining and selling the collateral, taking into account the amount and timing of these cash flows.[101] The wording does not mean that the entity is required to assume that recovery will be through foreclosure only, but rather, that the entity must calculate the cash flows arising from the various ways that the asset may be recovered, only some of which may involve foreclosure, and to probability-weight these different scenarios (see Example 3 at 4.4 above).

Although the standard does not refer to fair value when determining the valuation of the collateral, in practice, an entity is likely to estimate the cash flows from the realisation of the collateral, based on the fair value of the collateral. In the case of illiquid collateral, such as real estate, adjustments

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[100] *IFRS 9.B5.5.55*
[101] *IFRS 9.B5.5.55*

will probably need to be made for expected changes in the fair value, depending on the economic conditions at the estimated date of selling the collateral.

Also, as in IAS 39, any collateral obtained as a result of foreclosure is not recognised as an asset that is separate from the collateralised financial instrument, unless it meets the relevant recognition criteria for an asset in IFRS 9 or other standards.[102]

If a loan is guaranteed by a third party as part of its contractual terms, it must carry an allowance for ECLs based on the combined credit risk of the guarantor and the guaranteed party, by reflecting the effect of the guarantee in the measurement of losses expected on default.

Guarantees obtained should only be included in measuring ECLs if they are 'integral to the loan'.

A challenge is interpreting what constitutes 'part of the contractual terms'. This was addressed by the ITG at its meeting in December 2015, specifically whether the credit enhancement must be an explicit term of the related asset's contract in order for it to be taken into account in the measurement of ECLs, or whether other credit enhancements that are not recognised separately can also be taken into account. The ITG noted that:

▸ The definition of credit losses states that, when estimating cash flows, an entity must include cash flows from the sale of collateral held or other credit enhancements that are integral to the contractual terms. Consequently, credit enhancements included in the measurement of ECLs must not be limited to those that are explicitly part of the contractual terms.

▸ An entity must apply its judgement in assessing what is meant by 'integral to the contractual terms' and in making that assessment, an entity should consider all relevant facts and circumstances. Also, an entity must not include cash flows from credit enhancements in the measurement of ECLs if the credit enhancement is accounted for separately. This is particularly important in order to avoid double counting.

▸ IFRS 7 requires disclosures to enable users of financial statements to understand the effect of collateral and other credit enhancements on the amounts arising from ECLs (see section 14).

Although not reflected in the official minutes of the ITG meeting, the IASB members highlighted during the course of the discussion that there was no intention to alter the treatment when drafting IFRS 9. In practice, under IAS 39, most banks incorporate guarantees as part of their measurement of losses given default.

The ITG also emphasised that paragraph B5.5.55 of IFRS 9 was drafted only with the intention to caution against double counting those credit enhancements that are already recognised separately, and was not intended to limit the inclusion of credit enhancements that were previously included in IAS 39 allowances for loan losses.

However, the ITG discussion does not fully answer the question of how to interpret when a financial guarantee is 'integral to the contractual terms' when it is not mentioned in the contractual terms of the loan.

It seems reasonably clear that a credit default swap on a loan entered into by the lender to mitigate its credit risk on the loan, would not normally be classed as integral to a loan's contractual terms. The second criterion mentioned in B5.5.55 is that the credit enhancement should not be recognised separately and separate accounting for a derivative is clearly required by IFRS 9. Also,

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[102] IFRS 9.B5.5.55

payment under a credit default swap does not normally require the holder of the instrument to have suffered the credit loss referenced by the swap. As a result, cash flows from a credit default swap that is accounted for as a derivative would not be included in the measurement of ECLs of the associated loan.

For a financial guarantee (as defined in IFRS 9), one view is that it is integral to the contractual terms of a loan only if it is, at least implicitly, part of the contractual terms of the loan. Examples of implicit contractual linkage might include:

▸ Inseparability: The financial guarantee is inseparable from the loan contract, i.e., the loan cannot be transferred without the guarantee.

▸ Local laws and regulations: Credit enhancements required by local laws and regulations that govern the loan contract, but that are not specifically in the contract itself. For example, in some jurisdictions legislation requires that lenders must take out financial guarantee contracts that contain little or no down payment in respect of certain loans.

▸ Business purpose: The guarantee and the loan have been contracted in contemplation of one another, i.e., the loan would not have been contracted without the guarantee.

▸ Market convention: The exposure and the financial guarantee are traded as a package in the market.

Another view is that any contract that meets the definition of a financial guarantee under IFRS 9 can be considered 'integral to the contractual terms' of the guaranteed loan, as long as the guarantee is entered to at the same time, or within a short time, after the loan is advanced. As the definition of a financial guarantee contract requires that the loan is specified in the contractual terms of the financial guarantee and it is necessary for the lender to incur a credit loss on the loan to be reimbursed, there is a clear contractual linkage that ensures that any credit loss incurred on the loan will be compensated by the financial guarantee and no compensation will arise on the financial guarantee unless a credit loss is actually incurred by the lender on the guaranteed loan.

Although it is not clear when a financial guarantee contract would be regarded as 'integral', this may not significantly affect the profit or loss recognition by the lender. A financial guarantee contract is likely to satisfy the definition of an insurance contract in IFRS 4 *Insurance Contracts,* but will be excluded from the scope of IFRS 4 because it is a direct insurance contract held by a policy holder (as opposed to a policyholder of a reinsurance contract).[103] It is therefore outside the scope of IFRS 9.[104] IFRS 4 points to paragraphs 10 to 12 of IAS 8 A*ccounting Policies, Changes in Accounting Estimates and Errors* which address situations where no IFRS specifically applies to a transaction, i.e., the holder of a financial guarantee contract will normally need to develop its accounting policy in accordance with the hierarchy in IAS 8.[105]

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[103] IFRS 4.4(f)
[104] IFRS 9.2.1(e)
[105] IFRS 4 IG2 Example 1.11

Applying the IAS 8 hierarchy, one possibility would be to look to IAS 37 and treat the guarantee as a right to a reimbursement in respect of the impairment loss. IAS 37 permits a reimbursement of a liability to be recognised as an asset when it is virtually certain that the reimbursement will be received if the obligation for which a provision has been established is settled.[106] In this instance, the benefit of the guarantee would be recognised as an asset to the extent it is virtually certain a recovery could be made if the lender were to suffer the impairment loss on the loan. One of the key advantages of a financial guarantee contract, compared to a normal insurance contract, is that they are typically drawn up using standard terms and conditions and there is often little doubt that an obligation would arise for the guarantor if the reference asset were to default. However, care should be taken to establish, based on the contractual terms of the arrangement, that a right to a recovery would, indeed, be virtually certain.

To record a reimbursement asset under IAS 37, it is less clear whether the credit risk of the guarantor needs to be assessed in determining whether recovery would be virtually certain, or whether the guarantor's credit risk would only be reflected in measuring the reimbursement asset. One view is that the guarantor would either have to present a very low credit risk or else the guarantee would itself need to be collateralised. In this case, care should also be taken to ensure that there is no correlation between the credit risk of the loan and that of the guarantee, as would be the case if the guarantor's financial strength were to reduce at the same time that the loan is likely to default. Applying this view, if a reimbursement is considered virtually certain, there would probably be no need also to reflect the guarantor's credit risk in the measurement of the asset. In contrast, the second view imposes a less stringent criterion for recognising an asset, but would reduce the recognised asset to reflect the probability that the guarantor may be unable to meet its obligation.

An alternative approach would be to look to IFRS 3, since it requires that all contingent liabilities are recognised on a business combination, whether or not they are probable. This is closer to the IFRS 9 notion of an expected credit loss than the contingent liability recognition threshold under IAS 37. IFRS 3 allows an indemnification asset to be recognised, measured on the same basis as the indemnified asset or liability, subject to any contractual limitations on its amount and, for an indemnification asset that is not subsequently measured at its fair value, subject also to management's assessment of the collectability of the indemnification asset.[107] Adopting this indemnification asset approach, the credit risk of the guarantor becomes a measurement, rather than a recognition issue. It would not be necessary to assess if the credit risk of the guarantor is very low, since credit risk is instead reflected in the measurement of the guarantee.

Whether an analogy is made to a reimbursement right under IAS 37 or an indemnification asset under IFRS 3, an asset may be recognised in respect of the guarantee, not exceeding the amount of the provision.[108] Except for the possible treatment of the guarantor's credit risk, using either of these approaches, the overall effect on profit or loss for the lender may be often

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[106] IAS 37.53
[107] IFRS3.57
[108] IAS 37.53, IFRS 3.57

the same as if the guarantee was included in the measurement of the ECL of the guaranteed asset. The right would, however, be presented as an asset rather than as a reduction of the impairment allowance.

Most guarantees require payment of a premium. To the extent that the guarantee is considered integral to the loan, it would be consistent with this notion to treat the cost of the guarantee as a transaction cost of making the loan. This means that the lender would add this cost to the initial carrying amount of the loan and so reduce the future EIR. It should not make a difference to the accounting for the loan whether the guarantee premium is paid upfront or in instalments over the life of the loan. If the premium is payable in instalments, it follows (at least, in theory, although the effect may not be material) that the full cost of the guarantee should be included in setting the loan's EIR.

It is less clear how to account for premiums paid for guarantees that are not considered integral to the loan. If the entity who makes a loan and, at the same time, pays for a guarantee, records both the unamortised cost of the guarantee plus also a reimbursement or indemnification asset equivalent to the 12-month ECLs, the total amount at which the guarantee is initially recorded in the financial statements will exceed its fair value. This is because the cost of the guarantee will already include the guarantor's expectations of future losses. One view is to consider this to be 'double counting' and so, to restrict the reimbursement/indemnification right to the excess (if any) of the ECL over the cost of the guarantee that is already reflected in the balance sheet.

There is another view that recognising both the unamortised cost of the guarantee and a reimbursement right/indemnification asset equal to the ECL is necessary to be consistent with the accounting for the loan. Another way of expressing this is to say that it is appropriate for the guarantee to be recorded at more than its initial fair value as the guaranteed loan is recorded initially at less than its fair value by a similar amount, i.e., the ECL. The subsequent amortisation of the cost of the guarantee would be balanced by the recognition of the credit spread in the interest earned on the loan.

Whatever view is taken on this issue, if the lender acquires the guarantee subsequent to making the loan and the loan has, in the meantime, increased in credit risk, it is likely that the lender will pay more for the guarantee, to reflect this increase in credit risk. If so, this additional amount will crystallise a loss for the lender and so should not be recorded as a reimbursement/indemnification right and a reversal of a previously recognised impairment loss.

We should add, as a word of warning, that IFRS 9 has been amended by IFRS 17 *Insurance Contracts*. The scope exclusion for financial guarantee contracts will change from those contracts that meet the definition of insurance contracts to those that are in the scope of IFRS 17. As the accounting by the holder of the guarantee is not in the scope of IFRS 17, it will, by default, be in the scope of IFRS 9. The accounting treatment under IFRS 9 for a financial asset that fails the 'solely payment of principle and interest' test is to measure it at fair value through profit or loss. Hence, unless the Board first amends IFRS 9, from years beginning on or after 1 January 2021 when IFRS 17 becomes effective, it would appear to be

no longer possible to recognise a reimbursement or indemnification right for over and above the fair value of a guarantee that is not considered 'integral' to the guaranteed loan.

There have also been some discussions in practice on whether financial assets that are considered to be in default (e.g., because payments are more than 90 days past due) but that are fully collateralised (so that there is no ECL) would qualify as credit-impaired and therefore have to be transferred to stage 3 (see 3.1 above). Although the definition of credit-impaired refers to 'a detrimental impact on the estimated future cash flows', it is not clear whether this should be read to include any recoveries from the realisation of collateral and IFRS 9 has no explicit requirements to consider collateral when assessing credit-impaired financial assets.

There are some strong arguments in favour of aligning the criteria for transferring an asset to stage 3 with those for assessing whether it is in default. First, IFRS 9 bases significant deterioration on risk of a default occurring and it would therefore seem inconsistent (and potentially confusing for users) if the value of collateral is considered for stage 3 allocation. Also, if collateral value were to influence the stage 3 allocation, this could result in some instability between stages 2 and 3, as exposures would potentially go back and forth depending on the collateral value.

Aligning stage 3 with the default status affects the scope of instruments to which the purchased or originated credit-impaired approach must be applied (see 3 above). However, for any exposure which is fully collateralised and where the expected loss is zero, classification as a purchased or originated credit-impaired financial asset, or classification between stages 1, 2 or 3 does not affect the accounting. If the expected loss is zero, it will not affect the EIR calculation.

Also, IFRS 7 requires a quantitative disclosure about the collateral held as security and other credit enhancements for financial assets that are credit-impaired at the reporting date (e.g. quantification of the extent to which collateral and other credit enhancements mitigate credit risk).[109]

4.8.2 Cash flows from the sale of a defaulted loan

At its meeting in December 2015, the ITG also discussed whether cash flows that are expected to be recovered from the sale on default of a loan could be included in the measurement of ECLs. ITG members noted that:

▸ Such cash flows should be included in the measurement of ECLs if:

(a) Selling the loan is one of the recovery methods that the entity expects to pursue in a default scenario

(b) The entity is neither legally nor practically prevented from realising the loan using that recovery method

And

(c) The entity has reasonable and supportable information upon which to base its expectations and assumptions

▸ In order to support an entity's expectation that loan sales would be used as a recovery method in a default scenario, an entity's past practice would be an important consideration. However, future expectations, which may differ from past practice, would also need to be considered. With respect to the amount of recovery proceeds to be included in the measurement of ECLs, an entity should consider relevant market related information relating to loan sale prices.

> If there are scenarios in which recovery will be achieved by selling the loans, these should be considered in measuring ECLs.

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[109] IFRS 7.35K(c)

- In these circumstances, the inclusion of recovery sale proceeds in the measurement of ECLs would be appropriate for financial instruments in stages 1, 2 and 3 (see section 3.1 above). This is because when measuring ECLs, IFRS 9 requires an entity to consider possible default scenarios for financial instruments in all three stages.

- Expected sale proceeds would only be relevant when considering the possibility that a credit loss occurs (i.e., in a default scenario) and would not be relevant when considering the possibility that no credit loss occurs (i.e., in a performing scenario). For example if, in the case of a particular loan, an entity concluded that there was a 10 per cent probability of default occurring, it would only be when considering the outcome of this default scenario that expected sale proceeds would be considered. If, in that default scenario, the entity expected to recover 30 per cent of the contractual cash flows of the loan through sale proceeds but only 25 per cent through continuing to hold, then the LGD would be 70 per cent rather than 75 per cent. In addition, the expected sale proceeds should be net of selling costs.

4.9   Reasonable and supportable information

IFRS 9 requires an entity to consider 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 that is relevant to the estimate of ECLs, including the effect of expected prepayments.[110]

4.9.1   Undue cost or effort

The term 'undue cost or effort' is not defined in IFRS 9, although it is clear from the guidance that information available for financial reporting purposes is considered to be available without undue cost or effort.[111]

Beyond that, although the standard explains that entities are not required to undertake an exhaustive search for information, it does include, as examples of relevant information, data from risk management systems, as described in 4.9.2 below.

What is available without undue cost or effort would be an area subject to management judgement in assessing the costs and associated benefits. This is consistent with the guidance in International Financial Reporting Standard for Small and Medium-sized Entities (IFRS for SMEs) in relation to the application of undue cost or effort. Paragraph 2.14B of IFRS for SMEs states that considering whether obtaining or determining the information necessary to comply with a requirement would involve undue cost or effort depends on the entity's specific circumstances and on management's judgement of the costs and benefits from applying that requirement. This judgement requires consideration of how the economic decisions of those that are expected to use the financial statements could be affected by not having that information. Applying a requirement would involve undue cost or effort by an SME if the incremental cost (for example, valuers' fees) or additional effort (for example, endeavours by employees) substantially exceed the benefits that those that are expected to use the SME's financial statements would receive from having the information. Paragraph 232 of the Basis for Conclusions to IFRS for SMEs further observes that:

> The term 'undue cost or effort' is not defined in IFRS 9, although it is clear from the guidance that information available for financial reporting purposes is considered to be available without undue cost or effort.

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[110] IFRS 9.5.5.17(c), B5.5.51
[111] IFRS 9.B5.5.49

- The undue cost or effort exemption is not intended to be a low hurdle. In particular, the IASB observed that it would expect that if an entity already had, or could easily and inexpensively acquire, the information necessary to comply with a requirement, any related undue cost or effort exemption would not be applicable. This is because, in that case, the benefits to the users of the financial statements of having the information would be expected to exceed any further cost or effort by the entity

- An entity must make a new assessment of whether a requirement will involve undue cost or effort at each reporting date

If the reporting entity is a bank, there would presumably be a higher hurdle to determine what credit risk information would require undue cost or effort, compared to a reporter that is not a bank, given that the benefit to users of its financial statements would be also expected to be higher. This is also an issue on which the Basel Committee has issued guidance (see 6.1 below).

4.9.2 Sources of information

The standard states that the information used should include factors that are specific to the borrower, general economic conditions and an assessment of both the current as well as the forecast direction of conditions at the reporting date. Entities may use various sources of data, both internal (entity-specific) data and external data that includes internal historical credit loss experience, internal ratings, credit loss experience of other entities for comparable financial instruments, and external ratings, reports and statistics. Entities that have no, or insufficient, sources of entity-specific data may use peer group experience for the comparable financial instrument (or groups of financial instruments).[112]

Although the ECLs reflect an entity's own expectations of credit losses, an entity should also consider observable market information about the credit risk of particular financial instruments.[113] Therefore, although entities with in-house economic teams will inevitably want to use their internal economic forecasts, while loss estimation models will be built based on historical data, they should not ignore external market data.

4.9.3 Information about past events, current conditions and forecasts of future economic conditions

One of the significant changes from the IAS 39 impairment requirements is that entities are not only required to use historical information (e.g., their credit loss experience) that is adjusted to reflect the effects of current conditions, but they are also required to consider how forecasts of future conditions would affect their historical data. Section 4.6 above contains a discussion of how this process needs to consider the existence of non-linearity in how expected losses will change with varying economic conditions and the need to assess multiple economic scenarios. This section explores some of the other challenges in forecasting future conditions and the consequent ECLs.

The degree of judgement that is required to estimate ECLs depends on the availability of detailed information. An entity is not required to incorporate detailed forecasts of future conditions over the entire expected life of a financial instrument. The standard notes that as the forecast horizon increases, the availability of detailed information decreases and the degree of judgement required to estimate ECLs increases. Therefore, an entity is not required to perform a detailed estimate for periods that are far in the future and may extrapolate projections from available, more detailed information.[114]

> Entities are not only required to use historical information (e.g., their credit loss experience) adjusted to reflect the effects of current conditions, but they must also consider how forecasts of future conditions would affect their historical data.

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[112] IFRS 9.B5.5.51
[113] IFRS 9.B5.5.54
[114] IFRS 9.B5.5.50

Most banks plan to apply either a 3-year or 5-year period over which macro-economic variables would be forecasted reliably.

Beyond the horizon to which economic conditions can be reliably forecast, the application guidance suggests that entities may often be able to assume that economic conditions revert to their long-term average.[115] There are at least two methods for how this might be done: either by reverting to the average immediately beyond the forecast horizon; or by adjusting the forecast data to the long-term average over a few years. The latter would, perhaps, more effectively make use of all reasonable and supportable information.

Historical information should be used as a starting point from which adjustments are made to estimate ECLs on the basis of reasonable and supportable information that incorporates both current and forward-looking information:[116]

- In most cases, adjustments would be needed to incorporate the effects that were not present in the past or to remove the effects that are not relevant for the future.

- In some cases, unadjusted historical information may be the best estimate, depending on the nature of the historical information and when it was calculated, compared to circumstances at the reporting date and the characteristics of the financial instrument being considered. But it should not be assumed to be appropriate in all circumstances.[117]

Additionally, when considering whether historical credit losses should be adjusted, an entity will need to consider various items, including:

- Whether the historical data captures ECLs that are through-the-cycle (i.e., estimates based on historical credit loss events and experience over the entire economic cycle) or point-in-time (i.e., estimates based on information, circumstances and events at the reporting date).

- The period of time over which its historical data has been captured and the corresponding economic conditions represented in that history. The historical data period may reflect unusually benign or harsh conditions unless it is long enough. Meanwhile, products, customers and lending behaviours all change over time. When using historical credit loss experience, it is important that information about historical credit losses is applied to groups that are defined in a manner that is consistent with the groups for which the historical credit losses were observed.

> The estimates of changes in ECLs must be directionally consistent with changes in related observable data from period to period.

The estimates of changes in ECLs should be directionally consistent with changes in related observable data from period to period (i.e., consistent with trends observed on payment status and macroeconomic data such as changes in unemployment rates, property prices, and commodity prices). Also, in order to reduce the differences between an entity's estimates and actual credit loss experience, the estimates of ECLs should be back-tested and re-calibrated, i.e., an entity should regularly review its inputs, assumptions, methodology and estimation techniques used as well as its groupings of sub-portfolios with shared credit risk characteristics (see 5.5 below).

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[115] IFRS 9.B5.5.54
[116] IFRS 9.B5.5.52
[117] IFRS 9.BC5.281

How we see it

Back testing will be considerably more challenging for forecasts over several years than may be the case for just the 12-month risk of default, because detailed information may not be available over the forecast horizon and the degree of judgement increases as the forecast horizon increases.[118] Also, economic forecasts are usually wrong, as reality is much more complex than can ever be effectively modelled. Therefore, it is probably not a useful exercise to back test macroeconomic assumptions against what actually transpires, but it is useful to back test whether, for a given macroeconomic scenario, credit losses increased or decreased as expected

In estimating ECLs, entities must consider how to bridge the gap between historical loss experience and current expectations. Estimating future economic conditions is only the first step of the exercise. Having decided what will happen to macroeconomic factors such as interest rates, house prices, unemployment and GDP growth, entities then need to decide how they translate into ECLs. This will need to reflect how such changes in factors affected defaults in the past. However, it is possible that the forecast combination of factors may have never been seen historically together.

We observe that banks are also trying to align IFRS 9 to their existing risk management practices. Many banks are making use of their regulatory capital calculation and stress testing frameworks for their IFRS 9 calculations. This manifests itself in many of the individual decisions that banks are making as part of their development of IFRS 9 methodologies (e.g., definitions of default and alignment to stress testing). It is likely that regulators and standard-setters will concur with this approach. Basel PDs are used as a starting point and there is a need for a different calibration for IFRS 9, in order to transform a Basel PD into an unbiased point in time metric and include forward looking expectations. Stress testing resources, previously working almost exclusively with capital issues, will likely play a major role in calculating lifetime ECLs, although the scenarios modelled for IFRS 9 will not be stressed. However, estimating losses (especially given the need to consider multiple scenarios) will still be challenging for many entities.

The ITG has discussed several aspects of the forecast of ECLs (see section 1.5 above). In April 2015, the ITG debated whether, and how, to incorporate events and new information about forecasts of future economic conditions that occur after the ECLs have been estimated. Due to operational practicality, entities may perform their ECL calculations before the reporting period end in order to publish their financial statements in a timely manner (e.g. forecasts of future economic conditions developed in November may be used as the basis for determining the ECLs at the reporting date as at 31 December). Further information may then become available after the period end. The ITG noted that:

- If new information becomes available before the reporting date, subject to materiality considerations in accordance with IAS 8, an entity is required to take into consideration this information in the assessment of significant increases in credit risk and the measurement of ECLs at the reporting date.

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[118] IFRS 9.B5.5.52, B5.5.53

IFRS 9 changes the way in which post balance sheet events should be considered.

▸ IFRS 9 does not specifically require new information that becomes available after the reporting date to be reflected in the measurement of ECLs at the reporting date. If new information becomes available between the reporting date and the date the financial statements are authorised for issue, an entity needs to apply judgement, based on the specific facts and circumstances, to determine whether it is an adjusting or non-adjusting event in accordance with IAS 10 *Events after the Reporting Period*. Similarly, materiality considerations apply in accordance with IAS 8.

▸ ECLs are similar in nature to the measurement of fair value at the reporting date, in that movements in fair value after the reporting date are generally not reflected in the measurement of fair value at the reporting date.[119] For example, a change in interest rates or the outcome of a public vote after the reporting date would not normally be regarded as adjusting events for the ECL calculation.

▸ However, ECLs are a probability-weighted estimate of credit losses at the reporting date (see section 4.6 above). Accordingly, the determination of ECLs should take into consideration relevant possible future scenarios based on a range of expectations at the reporting date, using the information available at that date. Hence, the probabilities attached to future expected movements in interest rates and expected outcomes of a future public vote based on information available at the reporting date would be reflected in the determination of ECLs at that date.

▸ Entities need robust processes and appropriate governance procedures for incorporating information, including forecasts of future economic conditions, to ensure transparent and consistent application of the impairment requirements in IFRS 9. This includes processes for updating ECLs for new information that becomes available after the initial modelling has taken place up until the reporting date.

At its meeting on 16 September 2015, the ITG examined two further questions about the use of forward-looking information:[120]

▸ The level at which forward-looking information should be incorporated – whether at the level of the entity or on a portfolio-by-portfolio basis.[121]

▸ How to determine what is reasonable and supportable forward-looking information and how to treat shock events with material, but uncertain, economic consequences, such as an independence referendum. The same considerations could apply to events such as natural disasters.[122]

With respect to the first issue, the ITG members confirmed that forward-looking information should be relevant for the particular financial instrument or group of financial instruments to which the impairment requirements are being applied. Different factors may be relevant to different financial instruments and, accordingly, the relevance of particular items of information may vary between financial instruments, depending on the specific drivers of credit risk. This is highlighted in Illustrative Example 5 for IFRS 9 (see Example 16 below), in which expectations about future levels of unemployment in a specific industry and specific region are only relevant to a sub-portfolio of mortgage loans in which the borrowers work in that industry in that specific region. Conversely, it was also noted that if different financial instruments or portfolios being assessed share some similar risk characteristics, then relevant forward-looking

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[119] IAS 10.11
[120] Transition Resource Group for Impairment of Financial Instruments, Agenda ref 4, *Forward-looking information*, 16 September 2015.
[121] IFRS 9.B5.5.16, B5.5.51
[122] IFRS 9.B5.5.49-54

information should be applied in a comparable and consistent manner to reflect those similar characteristics.

With respect to the second issue, the ITG members noted:

▸ There will be a spectrum of forward-looking information available, some of which will be reasonable and supportable and some of which will have little or no supportable basis. Determining the information that is relevant and reasonable and supportable and its impact on the assessment of significant increases in credit risk and measurement of ECLs can require a high level of judgement. In addition, it can be particularly challenging and difficult to determine the economic consequences (or 'second-order effects') of uncertain future outcomes. For example, while it may be possible to assess the likelihood of a particular event occurring, it may be more difficult to determine the effect of the event on the risk of a default occurring and/or on the credit loses that would be associated with that event using reasonable and supportable information.

▸ The objective of the IFRS 9 requirements for measuring ECLs is to reflect probability-weighted outcomes. Accordingly, information should not be excluded from the assessment of ECLs simply because:

(a) The event has a low or remote likelihood of occurring

Or

(b) The effect of that event on the credit risk or the amount of ECLs is uncertain

> **Even though future events are uncertain, entities should make a good faith effort to estimate their impact.**

▸ An entity should make an effort in good faith to estimate the impact of uncertain future events, including second-order effects, on the credit risk of financial instruments and the measurement of ECLs. The estimate should be based on all reasonable and supportable information that is relevant and available without undue cost and effort. Furthermore:

(a) Estimates of ECLs should reflect an entity's own expectations of credit losses; however, entities should be able to explain how they have arrived at their estimate and how it is based on reasonable and supportable information.

(b) Estimates of ECLs are, by their nature, approximations, which will be updated as more reasonable and supportable information becomes available over time.

(c) Information does not necessarily need to flow through a statistical model or credit-rating process in order to determine whether it is reasonable and supportable and relevant for a particular financial instrument or group of financial instruments.

▸ If an entity could determine that an uncertain event has an impact on the risk of a default occurring, then it should be possible to make an estimate of the impact on ECLs, despite the potentially large range of outcomes. However, in some exceptional cases, it was acknowledged that it may not be possible to estimate the impact on ECLs, despite an entity's best efforts.

> **If a lack of reliable and supportable information means that forward looking information cannot be included in the measurement of ECLs, this must be disclosed if the effect is likely to be material.**

▸ In this regard, the importance of disclosure of forward-looking information that is relevant, but that cannot be incorporated in the determination of significant increases in credit risk and/or the measurement of ECLs because of the lack of reasonable and supportable information was emphasised. Such disclosures should be consistent with the objective in IFRS 7, which is to enable users of the financial statements to understand the credit risk to which the entity is exposed.

▸ The need for good governance and processes in this area, because of the uncertainties and continually changing circumstances associated with forward-looking information. Furthermore, an entity should be able to explain what information it had considered and why that information had been included or excluded from the determination of ECLs.

This ITG discussion predated the discussion held in December 2015 on the use of probability-weighted multiple economic scenarios (see section 4.6 above) and some of the points that were noted by the ITG probably need to be updated in the context of the later discussion. For instance, the ITG members noted that the impact of scenarios for some uncertain future events, for which there is reasonable and supportable information, may need to be incorporated through the use of overlays to the 'base model' on a collective basis. In applying a multiple scenario approach, an entity will not use just one base model. Moreover, if the lender needs to estimate ECLs by considering multiple economic scenarios, it would follow that many shock events will be included in that process, with the event and its various possible consequences occurring in some scenarios and not in others. There may still need to be cases when the effect of shock events is added through an additional 'overlay' to the modelled calculation of ECLs but, if so, as noted by the ITG members, care needs to be taken to avoid double counting the consequences of the event with what has already been assumed in the model.

Banks will also need to take account of guidance from their regulators (see section 6.1 below).

The ITG members also noted that the effects of uncertain future events may need to be reflected in the assessment of whether there has been a significant increase in credit risk.

5 General approach: determining significant increases in credit risk

One of the major challenges in implementing the general approach in the IFRS 9 ECL model is to track and determine whether there have been significant increases in the credit risk of an entity's credit exposures since initial recognition.

The assessment of significant deterioration is key in establishing the point of switching between the requirement to measure an allowance based on 12-month ECLs and one that is based on lifetime ECLs. The standard is prescriptive that an entity cannot align the timing of significant increases in credit risk and the recognition of lifetime ECLs with the time when a financial asset is regarded as credit-impaired or to an entity's internal definition of default.[123] Financial assets should normally be assessed as having increased significantly in credit risk earlier than when they become credit-impaired (see section 3.1 above) or default occurs.[124]

As this area involves significant management judgement, entities are required to provide both qualitative and quantitative disclosures under IFRS 7 to explain the inputs, assumptions and estimation used to determine significant increases in credit risk of financial instruments and any changes in those assumptions and estimates (see section 14).[125]

At its meeting in December 2015, the ITG members reaffirmed that, unless a more specific exception applies, IFRS 9 requires an entity to assess whether

> **Because of the relationship between the expected life and the risk of default occurring, the change in credit risk cannot be assessed simply by comparing the change in the absolute risk of default over time, because the risk of default usually decreases as time passes if the credit risk is unchanged.**

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[123] IFRS 9.B5.5.21
[124] IFRS 9.B5.5.7
[125] IFRS 7.35F(a), 35G(a)(ii), 35G(c)

there has been a significant increase in credit risk for all financial instruments, including those with a maturity of 12 months or less. Consistently with this requirement, IFRS 7 requires corresponding disclosures that distinguish between financial instruments for which the loss allowance is equal to 12-month or lifetime ECLs. In addition, the ITG members noted that:

▸ The assessment of significant increases in credit risk is distinct from the measurement of ECLs as highlighted by paragraph 5.5.9 of IFRS 9. For example, a collateralised financial asset may have suffered a significant increase in credit risk, but owing to the value of the collateral there may not be an increase in the amount of ECLs even if measured on a lifetime rather than a 12-month basis

▸ Assessing changes in credit risk would be consistent with normal credit risk management practices

▸ The expected life of a financial instrument may change if it has suffered a significant increase in credit risk

Finally, the ITG noted the importance of the IFRS 7 disclosure requirements and observed that disclosing information regarding the increase in credit risk since initial recognition provides users of financial statements with useful information regarding the changes in the risk of default occurring in respect of that financial instrument (see section 14).

5.1   Change in the risk of a default occurring

In order to make the assessment of whether there has been significant credit deterioration, an entity should consider reasonable and supportable information that is available without undue cost or effort and compare:[126]

▸ The risk of a default occurring on the financial instrument over its life as at the reporting date

▸ The risk of a default occurring on the financial instrument over its life as at the date of initial recognition

For loan commitments, an entity should consider changes in the risk of a default occurring on the potential loan to which a loan commitment relates.

For financial guarantee contracts, an entity should consider the changes in the risk that the specified debtor will default.[127]

An entity is required to assess significant increases in credit risk based on the change in the risk of a default occurring over the expected life of the financial instrument rather than the change in the amount of ECLs.[128] In a departure from the Basel regulatory wording and to avoid suggesting that statistical models are required (including the PD approach), the IASB changed the terminology from 'probability of a default occurring' to 'risk of a default occurring'.[129]

In order to make the IFRS 9 impairment model operational, the IASB considered a number of alternative methods for determining significant increases in credit risk, but these were rejected for the following reasons:

▸ *Absolute level of credit risk*: The IASB considered whether an entity should be required to recognise lifetime ECLs on all financial instruments at, or above, a particular credit risk at the reporting date. Although this approach

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[126] *IFRS 9.5.5.9*
[127] IFRS 9.B5.5.8
[128] *IFRS 9.5.5.9*
[129] IFRS 9.BC5.157

is operationally simpler to apply (because an entity is not required to track changes in credit risk), such an approach would provide very different information. It would not approximate the economic effect of changes in credit loss expectations subsequent to initial recognition. In addition, it may also result in overstatement or understatement of ECLs, depending on the threshold set for recognising lifetime ECLs.[130] However, the IASB noted that an absolute approach could be used for portfolios of financial instruments with similar credit risk at initial recognition, by determining the maximum initial credit risk accepted and then comparing the maximum initial credit risk to the credit risk at the reporting date (see section 5.4.5 below).[131]

▸ *Change in the credit risk management objective*: The IASB also considered whether the assessment of significant deterioration should be based on whether an entity's credit risk management objective changes (e.g., monitoring of financial assets on an individual basis, or a change from collecting past due amounts to the recovery of these amounts). This approach is operationally relatively easy to apply. However, it is likely to have a similar effect to the IAS 39 incurred loss model and, hence, may result in a delayed recognition of ECLs.[132]

▸ *Credit underwriting policies*: The IASB further considered whether the change in the entity's credit underwriting limit for a particular class of financial instrument at the reporting date (i.e. an entity would not originate new loans on the same terms) should form the basis of assessing significant increase in credit risk. The IASB noted that this approach is similar to the absolute approach above. Moreover, the change in an entity's credit underwriting limits may be driven by other factors that are not related to a change in the credit risk of its borrowers (e.g., the entity may incorporate favourable terms to maintain a good business relationship or to increase lending), or that are dependent on circumstances existing at the reporting date that are not relevant to the particular vintages of financial instruments.[133]

Similar to measuring ECLs, an entity may use different approaches when assessing significant increases in credit risk for different financial instruments. An approach that does not include PD as an explicit input can be consistent with the impairment requirements as long as the entity is able to separate the changes in the risk of a default occurring from changes in other drivers of ECLs (e.g., collateral) and considers the following when making the assessment:[134]

▸ The change in the risk of a default occurring since initial recognition

▸ The expected life of the financial instrument

▸ Reasonable and supportable information that is available, without undue cost or effort, that may affect credit risk

In addition, because of the relationship between the expected life and the risk of default occurring, the change in credit risk cannot be assessed simply by comparing the change in the absolute risk of default over time, because the risk of default usually decreases as time passes if the credit risk is unchanged.*[135]*

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[130] IFRS 9.BC5.160
[131] IFRS 9.BC5.161
[132] IFRS 9.BC5.162
[133] IFRS 9.BC5.163, BC5.164, BC5.165
[134] IFRS 9.B5.5.12
[135] IFRS 9.B5.5.11

Entities that do not use probability of loss as an explicit input will have to use other criteria to identify a change in the risk of default occurring. These might include deterioration in a behavioural score, or other indicators, of a heightened risk of default. A collective approach may also be an appropriate supplement or substitute for an assessment at the individual instrument level (see section 5.5 below).

A number of operational simplifications and presumptions are available to help entities make this assessment (as described further below).

5.1.1 Impact of collateral, credit enhancements and financial guarantee contracts

As already stressed, the assessment is based on the change in the lifetime risk of default, not the amount of ECLs. Hence, the allowance for a fully collateralised asset may need to be based on lifetime ECLs (because there has been a significant increase in the risk of default) even though no loss is expected to arise.[136] In such instances, the fact that the asset is being measured using lifetime ECLs may have more significance for disclosure than for measurement (see section 14 below).

The interaction between collateral, assessment of significant increases in credit risk and measurement of ECLs is illustrated in the following example from the standard.[137]

> **Example 7: Highly collateralised financial asset**
>
> Company H owns real estate assets which are financed by a five-year loan from Bank Z with a loan-to-value (LTV) ratio of 50 per cent. The loan is secured by a first-ranking security over the real estate assets. At initial recognition of the loan, Bank Z does not consider the loan to be credit-impaired as defined in Appendix A of IFRS 9.
>
> Subsequent to initial recognition, the revenues and operating profits of Company H have decreased because of an economic recession. Furthermore, expected increases in regulations have the potential to further negatively affect revenue and operating profit. These negative effects on Company H's operations could be significant and ongoing.
>
> As a result of these recent events and expected adverse economic conditions, Company H's free cash flow is expected to be reduced to the point that the coverage of scheduled loan payments could become tight. Bank Z estimates that a further deterioration in cash flows may result in Company H missing a contractual payment on the loan and becoming past due.
>
> Recent third party appraisals have indicated a decrease in the value of the real estate properties, resulting in a current LTV ratio of 70 per cent.
>
> At the reporting date, the loan to Company H is not considered to have low credit risk in accordance with paragraph 5.5.10 of IFRS 9. Bank Z therefore needs to assess whether there has been a significant increase in credit risk since initial recognition in accordance with paragraph 5.5.3 of IFRS 9, irrespective of the value of the collateral it holds. It notes that the loan is subject to considerable credit risk at the reporting date because even a slight deterioration in cash flows could result in Company H missing a contractual payment on the loan. As a result, Bank Z determines that the credit risk (i.e. the risk of a default occurring) has increased significantly since initial recognition. Consequently, Bank Z recognises lifetime ECLs on the loan to Company H.
>
> Although lifetime ECLs should be recognised, the measurement of the ECLs will reflect the recovery expected from the collateral (adjusting for the costs of obtaining and selling the collateral) on the property as required by paragraph B5.5.55 of IFRS 9 and may result in the ECLs on the loan being very small.

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[136] *IFRS 9.5.5.9*
[137] IFRS 9 IG Example 3 IE18-IE23

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An exposure may need to be transferred to stage 2 (because there has been a significant increase in the risk of a default occuring) even though no loss is expected to arise due to collateral.

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The ITG (see 1.5 above) discussed, in April 2015, whether an entity should consider the ability to recover cash flows through a financial guarantee contract that is integral to the contract when assessing whether there has been a significant increase in the credit risk of the guaranteed debt instrument since initial recognition. IFRS 9 requires that measurement of the ECLs of the guaranteed debt instrument includes cash flows from the integral financial guarantee contract (see 4.8.1 above).[138] However, some ITG members commented that IFRS 9 is clear that recoveries from integral financial guarantee contracts should be excluded from the assessment of significant increases in credit risk of the guaranteed debt instrument.[139] This is because the focus of the standard is about the risk of the borrower defaulting when making such an assessment, as highlighted in the examples in B5.5.17 of the standard. These examples clarify that information about a guarantee (or other credit enhancement) may be relevant to assessing changes in credit risk, but only to the extent that it affects the likelihood of the borrower defaulting on the instrument (see section 5.2.1 below for the list of examples).[140] Furthermore, excluding recoveries from the financial guarantee contract, when assessing significant increases in credit risk, would be consistent with the treatment of other forms of collateral.

While the value of collateral does not normally affect the assessment of significant increases in credit risk, if significant changes in the value of the collateral supporting the obligation are expected to reduce the borrower's economic incentive to make scheduled contractual payments, then this would have an effect on the risk of a default occurring. The standard provides an example where, if the value of collateral declines because house prices decline, borrowers in some jurisdictions have a greater incentive to default on their mortgages.[141]

The other examples provided by the standard of situations where the value of a credit enhancement could have an impact on the ability or economic incentive of the borrower to repay relate to guarantees or financial support provided by a shareholder, parent entity or other affiliate and to interests issued in securitisations:

▸ A significant change in the quality of the guarantee provided by a shareholder (or an individual's parent) if the shareholder (or parent) has an incentive and financial ability to prevent default by capital or cash infusion.[142]

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[138] IFRS 9.B5.5.55
[139] IFRS 9.5.5.9
[140] IFRS 9.B5.5.17
[141] IFRS 9.B5.5.17(j)
[142] IFRS 9.B5.5.17(k)

- Significant changes, such as reductions, in financial support from a parent entity or other affiliate or an actual or expected significant change in the quality of credit enhancement, that are expected to reduce the borrower's ability to make scheduled contractual payments. For example, such a situation could occur if a parent decides to no longer provide financial support to a subsidiary, which, as a result, would face bankruptcy or receivership. This could, in turn, result in that subsidiary prioritising payments for its operational needs (such as payroll and crucial suppliers) and assigning a lower priority to payments on its financial debt, resulting in an increase in the risk of default on those liabilities. Credit quality enhancements or support include the consideration of the financial condition of the guarantor and/or, for interests issued in securitisations, whether subordinated interests are expected to be capable of absorbing ECLs (for example, on the loans underlying the security).[143]

5.1.2 Contractually linked instruments (CLIs) and subordinated interests

The last example in the previous section, referring to the effect of subordinated interests in a securitisation deserves some comment. IFRS 9 sets out rules to determine whether an investment in a CLI such as a tranche of a securitisation, qualifies to be measured at amortised cost or at fair value through other comprehensive income.[144] While some CLIs may pass the contractual cash flow characteristics test and, consequently, may be measured at amortised cost or fair value through other comprehensive income, the contractual cash flows of the individual tranches are normally based on a pre-defined waterfall structure (i.e., principal and interest are first paid on the most senior tranche and then successively paid on more junior tranches). Consequently, CLIs do not default. Meanwhile, Appendix A of IFRS 9 defines 'credit loss' as 'the difference between all contractual cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive, discounted at the original effective interest rate'. Under the contract, the issuer of a CLI only passes cash flows that it actually receives, so the contractually defined cash flows under the waterfall structure are always equal to the cash flows that a holder expects to receive. Accordingly, one could argue that CLIs never give rise to a credit loss, and so would never be regarded as impaired.

How we see it

Consistent with treating these assets at amortised cost because they meet the SPPI criterion, for the purposes of the standard, the contractual terms of the CLI are deemed to give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding. Hence, we believe that for the purposes of the impairment requirements of IFRS 9, the lender needs to consider the deemed principal and interest payments as the contractual cash flows when calculating ECLs, instead of the cash flows determined under the waterfall structure. Accordingly, any failure of the instrument to pay the investor the full amount deemed to be due must be treated as a default and an estimation of the amount of any losses that will be incurred must be reflected in the credit loss allowance.

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[143] IFRS 9.B5.5.17(l)
[144] IFRS 9.4.1.2-4.1.2A, B4.1.20-B4.1.26

It also follows that paragraph B5.5.17(l) should be interpreted as saying that the investment should be measured based on lifetime ECLs if there are sufficient losses expected on the instruments underlying the securitisation such that they may not be absorbed by subordinated interests in the structure, and so there is a significantly increased risk that the investor will suffer loss.

5.1.3 Determining change in the risk of a default under the loss rate approach

Under the loss rate approach, introduced at 4.4.2 above, an entity develops loss-rate statistics on the basis of the amount written off over the life of the financial assets rather than using separate PD and LGD statistics. Entities then must adjust these historical credit loss trends for current conditions and expectations about the future.

The standard is clear that although a loss rate approach may be applied, an entity needs to be able to separate the changes in the risk of a default occurring from changes in other drivers of ECLs for the purpose of assessing if there has been a significant increase in credit risk.[145] Under the loss rate approach, the entity does not distinguish between a risk of a default occurring and the loss incurred following a default. This is not so much of an issue for measuring 12-month or lifetime ECLs. However, under the loss rate approach, an entity would not be able to implement the assessment of significant increases in credit risk that is based on the change in the risk of a default. Therefore, entities using the loss rate approach would need an overlay of measuring and forecasting the level of defaults, as illustrated in the extract of Example 9 from the Implementation Guidance (see Example 4 above). For entities that currently use only expected loss rates, it may be easier to develop a PD approach than to use the method described in this example.

5.2 Factors or indicators of changes in credit risk

Similar to measuring ECLs (see 4 above), when assessing significant increases in credit risk, an entity should consider all reasonable and supportable information that is available without undue cost or effort (see 4.9.1 above) and that is relevant for an individual financial instrument, a portfolio, portions of a portfolio, and groups of portfolios.[146]

The IASB did not intend to prescribe a specific or mechanistic approach to assess changes in credit risk and the appropriate approach will vary for different levels of sophistication of entities, the financial instrument and the availability of data.

The IASB notes that it did not intend to prescribe a specific or mechanistic approach to assess changes in credit risk and that the appropriate approach will vary for different levels of sophistication of entities, the financial instrument and the availability of data.[147] It is important to stress that the assessment of significant increases in credit risk often involves a multifactor and holistic analysis. The importance and relevance of each specific factor will depend on the type of product, characteristics of the financial instruments and the borrower as well as the geographical region.[148] The guidance in the standard is clear that, in certain circumstances, qualitative and non-statistical quantitative information may be sufficient to determine that a financial instrument has met the criterion for the recognition of lifetime ECLs. That is, the information does not need to flow through a statistical model or credit ratings process in order to determine whether there has been a significant increase in the credit risk of the financial instrument. In

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[145] IFRS 9.B5.5.12
[146] IFRS 9.B5.5.15, B5.5.16
[147] IFRS 9.BC5.157
[148] IFRS 9.B5.5.16

other cases, the assessment may be based on quantitative information or a mixture of quantitative and qualitative information.[149]

5.2.1 Examples of factors or indicators of changes in credit risk

The standard provides a non-exhaustive list of factors or indicators which an entity should consider when determining whether the recognition of lifetime ECLs is required. This list of factors or indicators is, as follows:[150]

- Significant changes in internal price indicators of credit risk as a result of a change in credit risk since inception, including, but not limited to, the credit spread that would result if a particular financial instrument, or similar financial instrument with the same terms and the same counterparty were newly originated or issued at the reporting date.

- Other changes in the rates or terms of an existing financial instrument that would be significantly different if the instrument was newly originated or issued at the reporting date (such as more stringent covenants, increased amounts of collateral or guarantees, or higher income coverage) because of changes in the credit risk of the financial instrument since initial recognition.

- Significant changes in external market indicators of credit risk for a particular financial instrument or similar financial instruments with the same expected life. Changes in market indicators of credit risk include, but are not limited to: the credit spread; the credit default swap prices for the borrower; the length of time or the extent to which the fair value of a financial asset has been less than its amortised cost; and other market information related to the borrower (such as changes in the price of a borrower's debt and equity instruments). The IASB noted that market prices are an important source of information that should be considered in assessing whether credit risk has changed, although market prices themselves cannot solely determine whether significant deterioration has occurred because market prices are also affected by non-credit risk related factors such as changes in interest rates or liquidity risks.[151]

- An actual or expected significant change in the financial instrument's external credit rating.

- An actual or expected internal credit rating downgrade for the borrower or decrease in behavioural scoring used to assess credit risk internally. Internal credit ratings and internal behavioural scoring are more reliable when they are mapped to external ratings or supported by default studies.

- Existing or forecast adverse changes in business, financial or economic conditions that are expected to cause a significant change in the borrower's ability to meet its debt obligations, such as an actual or expected increase in interest rates or an actual or expected significant increase in unemployment rates.

- An actual or expected significant change in the operating results of the borrower. Examples include actual or expected declining revenues or margins, increasing operating risks, working capital deficiencies, decreasing asset quality, increased balance sheet leverage, liquidity, management problems or changes in the scope of business or organisational structure (such as the discontinuance of a segment of the business) that result in a significant change in the borrower's ability to meet its debt obligations.

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[149] IFRS 9.B5.5.18
[150] IFRS 9.B5.5.17
[151] IFRS 9.BC5.123

- Significant increases in credit risk on other financial instruments of the same borrower.

- An actual or expected significant adverse change in the regulatory, economic, or technological environment of the borrower that results in a significant change in the borrower's ability to meet its debt obligations, such as a decline in the demand for the borrower's sales product because of a shift in technology.

- Significant changes in the value of the collateral supporting the obligation or in the quality of third-party guarantees or credit enhancements, which are expected to reduce the borrower's economic incentive to make scheduled contractual payments or to otherwise have an effect on the risk of a default occurring. For example, if the value of collateral declines because house prices decline, borrowers in some jurisdictions have a greater incentive to default on their mortgages.

- A significant change in the quality of the guarantee provided by a shareholder (or an individual's parents) if the shareholder (or parents) have an incentive and financial ability to prevent default by capital or cash infusion.

- Significant changes, such as reductions, in financial support from a parent entity or other affiliate or an actual or expected significant change in the quality of credit enhancement, that are expected to reduce the borrower's economic incentive to make scheduled contractual payments. For example, such a situation could occur if a parent decides to no longer provide financial support to a subsidiary, which as a result would face bankruptcy or receivership. This could in turn result in that subsidiary prioritising payments for its operational needs (such as payroll and crucial suppliers) and assigning a lower priority to payments on its financial debt, resulting in an increase in the risk of default on those liabilities. Credit quality enhancements or support include the consideration of the financial condition of the guarantor and/or, for interests issued in securitisations, whether subordinated interests are expected to be capable of absorbing ECLs (for example, on the loans underlying the security).

- Expected changes in the loan documentation (i.e. changes in contract terms) including an expected breach of contract that may lead to covenant waivers or amendments, interest payment holidays, interest rate step-ups, requiring additional collateral or guarantees, or other changes to the contractual framework of the instrument.

- Significant changes in the expected performance and behaviour of the borrower, including changes in the payment status of borrowers in the group (for example, an increase in the expected number or extent of delayed contractual payments or significant increases in the expected number of credit card borrowers who are expected to approach or exceed their credit limit or who are expected to be paying the minimum monthly amount).

- Changes in the entity's credit management approach in relation to the financial instrument, i.e. based on emerging indicators of changes in the credit risk of the financial instrument, the entity's credit risk management practice is expected to become more active or to be focused on managing the instrument, including the instrument becoming more closely monitored or controlled, or the entity specifically intervening with the borrower.

- Past due information, including the more than 30 days past due rebuttable presumption (see section 5.2.2 below).

Banks are encouraged to use the list of factors or indicators contained in the guidance to the standard to calibrate their criteria for their staging analysis.

This list raises the question as to whether an entity will be required to look at each of these factors or indicators as soon as the information is readily available, even though they may not be fully integrated in the entity's credit risk management systems and processes. This relates to our earlier discussion about which information is available without undue cost or effort (see section 4.9.1 above) and the Basel guidance (discussed at 6.1 below).

How we see it

▶ Many financial institutions should have readily available information about the pricing and terms of various types of loans issued to a specific customer (e.g. overdraft, credit cards and mortgage loans) in their credit risk management systems and processes. However, in practice, it would often be difficult to use such information because changes in pricing and terms on the origination of a similar financial instrument at the reporting date may not be so obviously related to a change in credit risk as other, more commercial, factors come into play (e.g., different risk appetites, change in management approach and underwriting standards). It may be challenging to link the two sets of information (i.e., pricing processes on the one hand and credit risk management on the other).

▶ Some collateralised loans are subject to cash variation margining requirements, which means that the trigger for default is normally the inability to pay a margin call. Therefore, in such circumstances the PD may be driven by the value of the collateral and changes in collateral values may need to be reflected in the staging assessment.

▶ Some of the factors or indicators are only relevant for the assessment of significant deterioration on an individual basis and not on a portfolio basis. For example, change in external market indicators of credit risk, including the credit spread, the credit default swap prices of the borrower and the extent of decline in fair value. However, it is worth noting that external market information that is available for a quoted instrument may be useful to help assess another instrument that is not quoted but which is issued by the same debtor or one who operates in the same sector.

▶ It is important to stress that the approach required by the standard is more holistic and qualitative than is necessarily captured by external credit ratings, which are adjusted for discrete events and may not reflect gradual degradations in credit quality. External credit ratings should not, therefore, be used on their own, but only in conjunction with other qualitative information. Furthermore, although ratings are forward-looking, it is sometimes suggested that changes in credit ratings may not be reflected in a timely matter. Therefore, entities may have to take account of expected change in ratings in assessing whether exposures are low risk (See example 12 below) illustrates that there could be significant differences between using agencies' credit ratings or using market data such as CDS spreads). The same point can, of course, be made about the use of internal credit ratings, especially if they are only reassessed on an annual basis.

At the September 2015 meeting, the ITG observed that credit grading systems were not designed with the requirements of IFRS 9 in mind, and thus it should not be assumed that they will always be an appropriate means of identifying significant increases in credit risk. The appropriateness of using internal credit grading systems as a means of assessing changes in credit risk since initial recognition depends on whether the credit grades are reviewed with sufficient

frequency, include all reasonable and supportable information and reflect the risk of default over the expected life of the financial instrument. As credit grading systems vary, care needs to be taken when referring to movements in credit grades and how this reflects an increased risk of default occurring. In addition, the assessment of whether a change in credit risk grade represents a significant increase in credit risk in accordance with IFRS 9 depends on the initial credit risk of the financial instrument being assessed. Because the relationship between credit grades and changes in the risk of default occurring differs between credit grading systems (e.g., in some cases the changes in the risk of a default occurring may increase exponentially between grades, whereas in others, it may not), this requires particular consideration. Also, some of the factors or indicators are very forward-looking, such as forecasts of adverse changes in business, financial or economic conditions that are expected to result in significant future financial difficulty of the borrower in repaying its debt. In practice, the analysis may have to be performed at the level of a portfolio rather than at an individual level when forward-looking information is not available at the individual level.

How we see it

Whilst IFRS 9 is not prescriptive, we observe differences in how banks intend to implement the assessment of significant increase in credit risk. These differences reflect various schools of thought along with differences in credit processes, business model, sophistication, use of advanced models for regulatory capital purposes, availability of data (e.g., historic data at origination) and consistency of definitions across businesses or multiple systems. As use of models and availability of data can vary within a bank, it is probable that a number of approaches will be adopted within a single institution.

In general, banks are considering the use of a combination of quantitative and qualitative drivers to assess significant increases in credit risk. Some of these are regarded as primary, others as secondary and some as backstops. The primary driver is usually expected to be the most forward looking indicator and is generally based on a relative measure. The most common primary drivers being considered by the larger banks are.

▶ Changes in the lifetime risk of a default occurring, guided by scores and ratings

▶ Changes in the lifetime or 12-month probability of default

Or

▶ Changes in ratings or credit scores for retail exposures and ratings for corporate exposures

Forbearance and watch lists are likely to be used as secondary drivers and delinquency, usually 30 days past due, as a backstop (see section 5.2.2 below).

5.2.2 Past due status and more than 30 days past due rebuttable presumption

The IASB is concerned that past due information is a lagging indicator. Typically, credit risk increases significantly before a financial instrument becomes past due or other lagging borrower-specific factors (for example, a modification or restructuring) are observed. Consequently, when reasonable and supportable information that is more forward-looking than past due

information is available without undue cost or effort, it must be used to assess changes in credit risk and an entity cannot rely solely on past due information.[152] However, the IASB acknowledged that many entities manage credit risk on the basis of information about past due status and have a limited ability to assess credit risk on an instrument-by-instrument basis in more detail on a timely basis.[153] Therefore, if more forward-looking information (either on an individual or collective basis) is not available without undue cost or effort, an entity may use past due information to assess changes in credit risks.[154]

Whether the entity uses only past due information or also more forward looking information (e.g., macroeconomic indicators), there is a rebuttable presumption that the credit risk on a financial asset has increased significantly since initial recognition, when contractual payments are more than 30 days past due. However, the standard seems to make it clear that it is not possible to rebut the 30 days past due presumption just because of a favourable economic outlook.[155] The IASB decided that this rebuttable presumption was required to ensure that application of the assessment of the increase in credit risk does not result in a reversion to an incurred loss notion.[156]

Moreover, as already stressed earlier, the standard is clear that an entity cannot align the definition and criteria used to identify significant increases in credit risk (and the resulting recognition of lifetime ECLs) to when a financial asset is regarded as credit-impaired or to an entity's internal definition of default.[157] An entity should normally identify significant increases in credit risk and recognise lifetime ECLs before default occurs or the financial asset becomes credit-impaired, either on an individual or collective basis (see section 5.5 below).

An entity can rebut the 30 days past due presumption if it has reasonable and supportable information that is available without undue cost or effort, that demonstrates that credit risk has not increased significantly even though contractual payments are more than 30 days past due.[158] Such evidence may include, for example, knowledge that a missed non-payment is because of administrative oversight rather than financial difficulty of the borrower, or historical information that suggests significant increases in credit risks only occur when payments are more than 60 days past due.[159]

5.2.3   *Illustrative examples of assessing significant increases in credit risk*

The consideration of various factors or indicators when assessing significant increases in credit risk since initial recognition is illustrated in Examples 8 and 9, which are based on Examples 1 and 2 in the Implementation Guidance for the standard.[160]

Example 8: Significant increase in credit risk

Company Y has a funding structure that includes a senior secured loan facility with different tranches. The security on the loan affects the loss that would be realised if a default occurs, but does not affect the risk of a default occurring, so it is not considered when determining whether there has been a significant increase in credit risk since initial recognition as required by paragraph 5.5.3 of IFRS 9. Bank X provides a tranche of that loan facility to Company Y. At the time of origination of the loan

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[152] IFRS 9.5.5.11, B5.5.2
[153] IFRS 9.BC5.192
[154] IFRS 9.5.5.11
[155] IFRS 9.5.5.11, B5.5.19
[156] IFRS 9.BC5.190
[157] IFRS 9.B5.5.21
[158] IFRS 9.5.5.11
[159] IFRS 9.B5.5.20
[160] IFRS 9 IG Example 1 IE7-IE17, IG Example 2 IE7-IE17

Example 8: Significant increase in credit risk (cont'd)

by Bank X, although Company Y's leverage was relatively high compared with other issuers with similar credit risk, it was expected that Company Y would be able to meet the covenants for the life of the instrument. In addition, the generation of revenue and cash flow was expected to be stable in Company Y's industry over the term of the senior facility. However, there was some business risk related to the ability to grow gross margins within its existing businesses.

At initial recognition, because of the considerations outlined above, Bank X considers that, despite the level of credit risk at initial recognition, the loan is not an originated credit-impaired loan because it does not meet the definition of a credit-impaired financial asset in Appendix A of IFRS 9.

Subsequent to initial recognition, macroeconomic changes have had a negative effect on total sales volume and Company Y has underperformed on its business plan for revenue generation and net cash flow generation. Although spending on inventory has increased, anticipated sales have not materialised. To increase liquidity, Company Y has drawn down more on a separate revolving credit facility, thereby increasing its leverage ratio. Consequently, Company Y is now close to breaching its covenants on the senior secured loan facility with Bank X.

Bank X makes an overall assessment of the credit risk on the loan to Company Y at the reporting date, by taking into consideration all reasonable and supportable information that is available without undue cost or effort and that is relevant for assessing the extent of the increase in credit risk since initial recognition. This may include factors such as:

(a)   Bank X's expectation that the deterioration in the macroeconomic environment may continue in the near future, which is expected to have a further negative impact on Company Y's ability to generate cash flows and to de-leverage.

(b)   Company Y is closer to breaching its covenants, which may result in a need to restructure the loan or reset the covenants.

(c)   Bank X's assessment that the trading prices for Company Y's bonds have decreased and that the credit margins on newly originated loans have increased reflecting the increase in credit risk, and that these changes are not explained by changes in the market environment (for example, benchmark interest rates have remained unchanged). A further comparison with the pricing of Company Y's peers shows that reductions in the price of Company Y's bonds and increases in credit margin on its loans have probably been caused by company-specific factors.

(d)   Bank X has reassessed its internal risk grading of the loan on the basis of the information that it has available to reflect the increase in credit risk.

Bank X determines that there has been a significant increase in credit risk since initial recognition of the loan in accordance with paragraph 5.5.3 of IFRS 9. Consequently, Bank X recognises lifetime ECLs on its senior secured loan to Company Y. Even if Bank X has not yet changed the internal risk grading of the loan, it could still reach this conclusion – the absence or presence of a change in risk grading in itself is not determinative of whether credit risk has increased significantly since initial recognition.

Example 9: No significant increase in credit risk

Company C is the holding company of a group that operates in a cyclical production industry. Bank B provided a loan to Company C. At that time, the prospects for the industry were positive, because of expectations of further increases in global demand. However, input prices were volatile and given the point in the cycle, a potential decrease in sales was anticipated.

In addition, in the past, Company C has focused on external growth, acquiring majority stakes in other companies in related sectors. As a result, the group structure is complex and has been subject to change, making it difficult for investors to analyse the expected performance of the group and to forecast the cash that will be available at the holding company level. Even though leverage is at a level that is considered acceptable by Company C's creditors at the time that Bank B originates the loan, its creditors are concerned about Company C's ability to refinance its debt because of the short remaining life until the maturity of the current financing. There is also concern about Company C's ability to continue to service interest using the dividends it receives from its operating subsidiaries.

At the time of the origination of the loan by Bank B, Company C's leverage was in line with that of other customers with similar credit risk and based on projections over the expected life of the loan, the available capacity (i.e., headroom) on its coverage ratios before triggering a default event, was high. Bank B applies its own internal rating methods to determine credit risk and allocates a specific internal rating score to its loans. Bank B's internal rating categories are based on historical, current and forward-looking information and reflect the credit risk for the tenor of the loans. On initial recognition, Bank B determines that the loan is subject to considerable credit risk, has speculative elements and that the uncertainties affecting Company C, including the group's uncertain prospects for cash generation, could lead to default. However, Bank B does not consider the loan to be originated credit-impaired.

Subsequent to initial recognition, Company C has announced that three of its five key subsidiaries had a significant reduction in sales volume because of deteriorated market conditions, but sales volumes are expected to improve in line with the anticipated cycle for the industry in the following months. The sales of the other two subsidiaries were stable. Company C has also announced a corporate restructure to streamline its operating subsidiaries. This restructuring will increase the flexibility to refinance existing debt and the ability of the operating subsidiaries to pay dividends to Company C.

Despite the expected continuing deterioration in market conditions, Bank B determines, in accordance with paragraph 5.5.3 of IFRS 9, that there has not been a significant increase in the credit risk on the loan to Company C since initial recognition. This is demonstrated by factors that include:

(a)   Although current sale volumes have fallen, this was as anticipated by Bank B at initial recognition. Furthermore, sales volumes are expected to improve, in the following months.

(b)   Given the increased flexibility to refinance the existing debt at the operating subsidiary level and the increased availability of dividends to Company C, Bank B views the corporate restructure as being credit enhancing. This is despite some continued concern about the ability to refinance the existing debt at the holding company level.

(c)   Bank B's credit risk department, which monitors Company C, has determined that the latest developments are not significant enough to justify a change in its internal credit risk rating.

As a consequence, Bank B does not recognise a loss allowance at an amount equal to lifetime ECLs on the loan. However, it updates its measurement of the 12-month ECLs for the increased risk of a default occurring in the next 12 months and for current expectations of the credit losses that would arise if a default were to occur.

A numerical illustration of how a significant increase in credit risk might be assessed is shown in Example 10:

Example 10: Assessment of a significant increase in credit risk based on a PD approach

This example is based on the same loan presented in Example 3 above.

On 31 December 2015, Bank A originates a 10-year loan with a gross carrying amount of $1,000,000, interest being due at the end of each year. Based on statistical and qualitative information – including forward looking, Bank A has assigned a **BBB rating** for the loan.

Based on this rating, Bank A has computed a PD term structure at origination. Bank A's PD term structure is estimated with the annual PD expected for each future period. The lifetime PD is the product of each marginal PD during the considered period:

$$\text{lifetime PD}_k = 1 - \prod_{k=i}^{n} (1 - \text{marginal PD}_i)$$

Finally, based on the marginal PD computed for each future period, Bank A is able to compute the forward lifetime PD, as follows:

Year	Cumulative PD at origination	Marginal 12-month PD	Remaining lifetime PD	Remaining annualised lifetime PD
2016				
2017	0.17%	0.17%	4.50%	0.46%
2018	0.49%	0.32%	4.34%	0.49%
2019	0.86%	0.37%	4.03%	0.51%
2020	1.38%	0.53%	3.67%	0.53%
2021	1.84%	0.47%	3.16%	0.53%
2022	2.37%	0.54%	2.71%	0.55%
2023	2.85%	0.49%	2.18%	0.55%
2024	3.30%	0.46%	1.70%	0.57%
2025	3.84%	0.56%	1.24%	0.62%
2026	4.50%	0.69%	0.69%	0.69%

For the first year, the remaining lifetime PD is the cumulative PD at origination. Then, after a year, it starts decreasing, considering that the remaining period is shorter. After 2 years it is 4.03% and after 3 years it is only 3.67%. At the end of the loan, the remaining lifetime PD ends up at 0%.

In common with many institutions, Bank A chooses to compare an annualised lifetime PD instead of a cumulative PD. This has the advantage that business lines and risk analysts can easily map an annualised PD onto a rating scale. It also enables an absolute change in annualised lifetime PD, e.g. 20bp, to be set as a 'filter' to exclude small changes in lifetime PD from being assessed as significant that are considered to be 'noise'. For this purpose, Bank A calculates an annualised PD, using the residual cumulative curve. The annualised lifetime PD is calculated, as follows:

$$\text{annualised lifetime PD}_k = 1 - (1 - \text{lifetime PD}_k)^{1/t}$$

when t = horizon of the lifetime PD expressed in years

2018: no significant increase in credit risk: Stage 1

On 31 December 2018 – 2 years after origination, Bank A updates the rating of its obligor. The rating is now BB+.

A new PD term structure is estimated based on this information:

Year	Cumulative lifetime PD
2019	0.67%
2020	1.53%
2021	3.70%
2022	5.58%
2023	5.89%
2024	6.51%
2025	7.45%
2026	8.70%
Remaining annualised lifetime PD	1.13%
Forecast at origination	0.51%
Increase (multiple)	**2.20**

In this example, Bank A uses a significant increase in credit risk threshold of a 2.5 multiple of PD. For simplicity we ignore any qualitative or other indicators that a bank might use to make this assessment.

Comparing the remaining annualised PD estimated at origination (0.51%) with the remaining annualised PD at the reporting date (1.13%), the increase is still only ×2.2. We note that, had Bank A used a cumulative lifetime PD approach, it would compare 8.70% to 4.03%, which would also be a multiple of 2.2. The significant deterioration threshold set by Bank A is not met and therefore the loan remains in stage 1.

2019: significant increase in credit risk: stage 2

On 31 December 2019 - 3 years after origination, Bank A updates the rating of its obligor. Its rating is now BB-. Then Bank A updates its historical information for current economic conditions as well as reasonable and supportable forecasts of future economic conditions.

Year	Cumulative lifetime PD
2020	1.40%
2021	3.87%
2022	8.82%
2023	12.84%
2024	16.04%
2025	18.98%
2026	21.60%
Remaining annualised lifetime PD	3.42%
Forecast at origination	0.53%
Increase (multiple)	**6.41**

As before, Bank A compares the remaining annualised PD estimated at origination (0.53%) with the remaining annualised PD at the reporting date (3.42%), an increase of 6.45 times the original PD. Had Bank A used a cumulative lifetime PD approach, the comparison would be of 21.6% to 3.67%, a 6.41-fold increase. This time, the threshold of significant deterioration is met and the loan is moved to stage 2.

5.2.4 Use of behavioural factors

At its meeting on 16 September 2015, the ITG (see 1.5 above) discussed whether the following behavioural indicators of credit risk could be used, on their own, as a proxy to determine if there has been a significant increase in credit risk:

▸ Where a customer has made only the minimum monthly repayment for a specified number of months

▸ Where a customer has failed to make a payment on a loan with a different lender

Or

▸ Where a customer has failed to make a specified number of minimum monthly repayments

The ITG members noted that:

▸ When assessing whether there has been a significant increase in credit risk, entities are required to consider a range of indicators rather than focusing on only one. Furthermore, while behavioural indicators have a role to play, the above behavioural indicators are often lagging indicators of increases in credit risk. Consequently, they should be considered in conjunction with other, more forward-looking information. In this regard, an entity must consider how to source and incorporate forward-looking information into the assessment of significant increases in credit risk and may need to do this on a collective basis if forward-looking information is not available at an individual financial instrument level.

▸ When considering the use of behavioural indicators, an entity should:

   (a)   Focus on identifying pre-delinquency behavioural indicators of increases in credit risk, e.g., increased utilisation rates or increased cash drawings on specific products

   (b)   Only use indicators that are relevant to the risk of default occurring

   (c)   Establish a link between the behavioural indicators of credit risk and changes in the risk of default occurring since initial recognition.

   (d)   Be mindful that while behavioural indicators are often predictive of defaults in the short term, they are often less predictive of defaults in the longer term, and, hence, might be lagging. Consequently they may not, on their own, signal significant increases in credit risk in a timely manner.

   (e)   Consider whether the use of behavioural indicators is appropriate for the type of product being assessed, e.g., if a loan has only back-ended payments, behavioural indicators based on timeliness of payment will not be appropriate.

▸ An entity is required to consider all information available without undue cost and effort and it should not be limited by the information that is available internally. For example, an entity should consider using third-party information from sources such as credit bureaus. However, information that is available to entities will vary across jurisdictions.

▸ When making the assessment of significant increases in credit risk, an entity should consider the possibility of segmenting the portfolio into groups of financial instruments with shared credit characteristics in such a way that similar indicators of credit risk could be used to identify increases in credit risk for specific sub-portfolios.

▸ It would not be appropriate to use the above behavioural indicators for the purposes of identifying low credit risk assets in accordance with paragraph 5.5.10 of IFRS 9 (see section 5.2.4. below), on the basis that such measures would not constitute a globally accepted definition of low credit risk as required by IFRS 9.

> Behavioural information tends to be lagging data and should be supplemented by more forward-looking information.

Other behavioural indicators, beyond those mentioned above, including items such as the level of cash advances, changes in expected payment patterns (e.g., moving from full payment to something less than full payment), and higher-than-expected utilisation of the facility, were raised at the meeting. Individually, these kinds of behaviours may not be determinative of a significant increase in credit risk but, when observed together, they may prove to be more indicative. By combining these indicators, an entity has the potential to transfer assets between stage 1 and stage 2 more meaningfully.

We also note that that one of the challenges with using behavioural information is that it depends on the starting point. That is, if the obligor's risk of default initially is consistent with a super-prime rating, the kind of deteriorating behaviour noted above would likely signal a significant shift. However, if the obligor originally had a sub-prime rating, then such behaviour might not indicate a significant increase in risk.

As noted by the ITG, while indicators that are more lagging may show a greater correlation with subsequent default, they are also likely to be less forward-looking. Although a probability of default approach may seem more sophisticated and forward looking, it is still generally fed by behavioural information, even if it is combined, segmented and modelled in a more sophisticated way. If the only borrower-specific information is his behaviour, a forward looking portfolio overlay will generally be required, whether a PD or a behavioural approach is used.

5.3   What is significant?

The assessment of whether credit risk has significantly increased depends, critically, on an interpretation of the word 'significant'. Some constituents who commented on the 2013 Exposure Draft requested the IASB to quantify the term 'significant', however, the IASB decided not to do so, for the following reasons:[161]

▸ Specifying a fixed percentage change in the risk of default would require all entities to use the risk of default approach. As not all entities (apart from regulated financial institutions) use PDs as an explicit input, this would have increased the costs and effort for those entities that do not use such an approach

▸ Defining the amount of change in the risk of a default occurring would be arbitrary and this would depend on the type of products, maturities and initial credit risk

The standard emphasises that the determination of the significance of the change in the risk of a default occurring depends on:

▸ The original credit risk at initial recognition: the same absolute change in PD for   a financial instrument with a lower initial credit risk will be more significant than those with a higher initial credit risk (see 5.4.5 and Example 14).[162]

▸ The expected life or term structure: the risk of a default occurring for financial instruments with similar credit risk increases the longer the expected life of the financial instruments. Due to the relationship between the expected life and the risk of a default occurring, an entity cannot simply compare the absolute risk of a default occurring over time. For example, if the risk of a default occurring for a financial instrument with an expected life of 10 years at initial recognition is the same after five years, then this indicates that the credit risk has increased. The standard also states that, for financial instruments that have significant payment obligations close to the maturity of the financial instrument (e.g., those where the principal is only repaid at maturity), the risk of a default occurring may not necessarily decrease as time passes. In such cases, an entity needs to consider

The assessment of whether credit risk has significantly increased depends, critically, on an interpretation of the word 'significant'.

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[161] IFRS 9.BC5.171, BC5.172
[162] IFRS 9.B5.5.9

other qualitative factors. We note, however, that while the risk of default may decrease less quickly for an instrument with payment obligations throughout its contractual life, normally, the risk of default will still decrease as maturity approaches.[163]

Some of these challenges are illustrated by examining the historical levels of default associated with the credit ratings of agencies, such as Standard & Poor's:

▸ It is apparent that the PDs increase at a geometrical, rather than an arithmetic, rate as the credit ratings decline. Hence, the absolute increase in the PD between two relatively low risk credit ratings is considerably less than between two relatively higher risk ratings.

▸ The relative increase in PD between each of these ratings might be considered significant, since most involve a doubling or trebling of the PD. In contrast, because credit rating is an art rather than a science, the smaller changes in credit risk associated with the plus or minus notches in the grading system are less likely to be viewed as significant.

▸ In addition, as the time horizon increases, the PDs also increase across all credit ratings (i.e., the PD increases with a longer maturity).

The majority of credit exposures that are assessed for significant credit deterioration will not have been rated by a credit rating agency. However, the same logic will apply when entities have developed their own PD models and are able to classify their exposure by PD levels.

The determination of what is significant will, for the larger banks, be influenced by the guidance issued by banking regulators (see 6.1 below).

How we see it

Given the exponential shape of the PD curve relative to ratings, some banks consider that a bigger downgrade, as measured by the number of grades, would be significant for a higher quality loan than for one with a lower quality. The extent to which this is appropriate will depend on how the different grades map to PDs. Also, the calibration of a significant deterioration has to take into account the fact that PD multiples for very good ratings only represent very small movements in absolute risk, whereas the same multiple applied to bad ratings can represent a significant change in the absolute amount of PD.

Banks have varying views on how much of an increase in PD is significant. Some are thinking that a doubling of PD would be significant, but adding a minimum absolute PD increase, such as 50 basis point per year, so as to avoid very high quality assets moving to stage 2 as a result of a very small change and to filter out 'noise'.

Banks are also exploring various metrics to assess the effect of different approaches to assess significant increase in credit risk and for management information. Examples include the volume of stage 2 assets compared to the total portfolio and compared to 12-months of lifetime expected losses, the volume of movement (back and forth) between stages 1 and 2, the amount of assets that jump directly from stage 1 to stage 3, the proportion of assets in stage 3 which went via stage 2, and how long assets were in stage 2 before moving to stage 3.

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[163] IFRS 9.B5.5.10, B5.5.11

5.4 Operational simplifications

When assessing significant increases in credit risk, there are a number of operational simplifications available. These are discussed below.

5.4.1 Low credit risk operational simplification

The standard contains an important simplification that, if a financial instrument has a low credit risk, then an entity is allowed to assume at the reporting date that no significant increases in credit risk have occurred. The low credit risk concept was intended, by the IASB, to provide relief for entities from tracking changes in the credit risk of high quality financial instruments. This simplification is optional and the low credit risk simplification can be elected on an instrument-by-instrument basis.[164]

This is a change from the 2013 Exposure Draft, in which a low risk exposure was deemed not to have suffered significant deterioration in credit risk.[165] The amendment to make the simplification optional was made in response to requests from constituents, including regulators. The Basel Committee guidance (see section 6.1 below) considers the use of the low credit risk simplification a low-quality implementation of the ECL model and that the use of this exemption should be limited, except for holdings in securities.

For low risk instruments for which the simplification is used, the entity would recognise an allowance based on 12-month ECLs.[166] However, if a financial instrument is not, or no longer, considered to have low credit risk at the reporting date, it does not follow that the entity is required to recognise lifetime ECLs. In such instances, the entity has to assess whether there has been a significant increase in credit risk since initial recognition which requires the recognition of lifetime ECLs.[167]

The standard states that a financial instrument is considered to have low credit risk if:[168]

▸ The financial instrument has a low risk of default

▸ The borrower has a strong capacity to meet its contractual cash flow obligations in the near term

And

▸ Adverse changes in economic and business conditions in the longer term may, but will not necessarily, reduce the ability of the borrower to fulfil its contractual cash flow obligations

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[164] IFRS 9.BC5.184
[165] IFRS 9.BC5.181, BC5.182, BC5.183
[166] IFRS 9.5.5.10
[167] IFRS 9.5.5.24
[168] IFRS 9.5.5.22

A financial instrument is not considered to have low credit risk simply because it has a low risk of loss (e.g., for a collateralised loan, if the value of the collateral is more than the amount lent (see 4.8.11 above)) or it has lower risk of default compared to the entity's other financial instruments or relative to the credit risk of the jurisdiction within which the entity operates.[169]

The description of low credit risk is equivalent to investment grade quality assets, equivalent to Standard and Poor's rating of BBB- or better, Moody's rating of Baa3 or better and Fitch's rating of BBB- or better. When applying the low credit risk simplification, financial instruments are not required to be externally rated. However, the IASB's intention was to use a globally comparable notion of low credit risk instead of a level of risk determined, for example, by an entity or jurisdiction's view of risk based on entity-specific or jurisdictional factors.[170]   Therefore, an entity may use its internal credit ratings to assess low credit risk as long as this is consistent with the globally understood definition of low credit risk (i.e. investment grade) or the market's expectations of what is deemed to be low credit risk, taking into consideration the terms and conditions of the financial instruments being assessed.[171]

The Basel Committee guidance (see 6.1 below) states that the investment grade category used by ratings agencies is not considered sufficiently homogeneous to be automatically considered low credit risk, and internationally active and sophisticated banks are expected to rely primarily on their own credit assessments.

In practice, entities with internal credit ratings will attempt to map their internal rating to the external credit ratings and definitions, such as Standard & Poor's, Moody's and Fitch. The description of the credit quality ratings by these major rating agencies are illustrated below.[172]

Figure 5: External credit ratings and definitions from the 3 major rating agencies

Standard & Poor's	Moody's	Fitch
Investment grade would usually refer to categories AAA to BBB (with BBB- being lowest investment grade considered by market participants).	Investment grade would usually refer to categories Aaa to Baa (with Baa3 being lowest investment grade considered by market participants).	Investment grade would usually refer to categories AAA to BBB (with BBB- being lowest investment grade considered by market participants).
BBB	**Baa**	**BBB: Good credit quality**
Adequate capacity to meet financial commitments, but more subject to **adverse economic conditions**.	Obligations rated Baa are judged to be medium-grade and subject to moderate credit risk and as such may possess certain speculative characteristics.	Indicates that expectations of **default risk are currently low**. The capacity for payment of financial commitments is considered adequate but adverse business or economic conditions are more likely to impair this capacity.

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[169] IFRS 9.B5.5.22
[170] IFRS 9.BC5.188
[171] IFRS 9.B5.5.23
[172] IASB Agenda paper 5B, Financial Instruments: Impairment, Operational simplifications – 30dpd and low credit risk, 28 October – 1 November 2013.

Figure 5: External credit ratings and definitions from the 3 major rating agencies (cont'd)

The dividing line between investment grade and speculative grade		
BB	Ba	BB: Speculative
Less vulnerable in the near-term, but faces major on-going uncertainties due to adverse business, financial and economic conditions.	Obligations rated Ba are judged to be speculative and are subject to substantial credit risk.	Indicates an elevated vulnerability to default risk, particularly in the event of adverse changes in business or economic conditions over time. However, business or financial flexibility exists which supports the servicing of financial commitments.

Examining the historical levels of default associated with the credit ratings of agencies such as Standard & Poor's, the PD of a BBB-rated loan is approximately treble that of one that is rated A. Hence, many entities would consider the increase in credit risk to be significant, if the low risk simplification is not used.

The low credit risk simplification will not be relevant if an entity originates or purchases a financial instrument with a credit risk which is already non-investment grade. Similarly, this simplification will also have limited use when the financial instrument is originated or purchased with a credit quality that is marginally better than a non-investment grade (i.e., at the bottom of the investment grade rating), because any credit deterioration into the non-investment grade rating would require the entity to assess whether the increase in credit risk has been significant.

Partly because of the Basel Committee guidance, most sophisticated banks intend to apply the low risk simplification only to securities. It is yet to be seen whether less sophisticated banks will use this operational simplification widely for their loan portfolios. Investors that hold externally rated debt instruments are more likely to rely on external rating agencies data and use the low credit risk simplification. However, some sophisticated banks are intending not to use it at all, preferring to use the same criteria as for other exposures (e.g., changes in the lifetime risk of default as the primary indicator followed by other risk metrics such as credit scores and ratings). It is also important to emphasise that, although ratings are forward-looking, it is sometimes suggested that changes in credit ratings may not be reflected in a timely matter. Therefore, entities may have to take account of expected change in ratings in assessing whether exposures are low risk.

The following example from the standard illustrates the application of the low credit risk simplification.[173]

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[173] IFRS 9 IG Example 4 IE24-IE28

Example 11: Public investment-grade bond

Company A is a large listed national logistics company. The only debt in the capital structure is a five-year public bond with a restriction on further borrowing as the only bond covenant. Company A reports quarterly to its shareholders. Entity B is one of many investors in the bond. Entity B considers the bond to have low credit risk at initial recognition in accordance with paragraph 5.5.10 of IFRS 9. This is because the bond has a low risk of default and Company A is considered to have a strong capacity to meet its obligations in the near term. Entity B's expectations for the longer term are that adverse changes in economic and business conditions may, but will not necessarily, reduce Company A's ability to fulfil its obligations on the bond. In addition, at initial recognition the bond had an internal credit rating that is correlated to a global external credit rating of investment grade.

At the reporting date, Entity B's main credit risk concern is the continuing pressure on the total volume of sales that has caused Company A's operating cash flows to decrease.

Because Entity B relies only on quarterly public information and does not have access to private credit risk information (because it is a bond investor), its assessment of changes in credit risk is tied to public announcements and information, including updates on credit perspectives in press releases from rating agencies.

Entity B applies the low credit risk simplification in paragraph 5.5.10 of IFRS 9. Accordingly, at the reporting date, Entity B evaluates whether the bond is considered to have low credit risk using all reasonable and supportable information that is available without undue cost or effort. In making that evaluation, Entity B reassesses the internal credit rating of the bond and concludes that the bond is no longer equivalent to an investment grade rating because:

(a) The latest quarterly report of Company A revealed a quarter-on-quarter decline in revenues of 20 per cent and in operating profit by 12 per cent.

(b) Rating agencies have reacted negatively to a profit warning by Company A and put the credit rating under review for possible downgrade from investment grade to non-investment grade. However, at the reporting date the external credit risk rating was unchanged.

(c) The bond price has also declined significantly, which has resulted in a higher yield to maturity. Entity B assesses that the bond prices have been declining as a result of increases in Company A's credit risk. This is because the market environment has not changed (for example, benchmark interest rates, liquidity, etc. are unchanged) and comparison with the bond prices of peers shows that the reductions are probably company specific (instead of being, for example, changes in benchmark interest rates that are not indicative of company-specific credit risk).

While Company A currently has the capacity to meet its commitments, the large uncertainties arising from its exposure to adverse business and economic conditions have increased the risk of a default occurring on the bond. As a result of the factors described above, Entity B determines that the bond does not have low credit risk at the reporting date. As a result, Entity B needs to determine whether the increase in credit risk since initial recognition has been significant. On the basis of its assessment, Company B determines that the credit risk has increased significantly since initial recognition and that a loss allowance at an amount equal to lifetime ECLs should be recognised in accordance with paragraph 5.5.3 of IFRS 9.

Some of the challenges in assessing whether there has been a significant increase in credit risk (including the use of the low credit risk simplification) and estimating the ECLs, are illustrated in the following example. It illustrates different ways of identifying a significant change in credit quality and different input parameters for calculating ECLs for a European government bond, which result in very different outcomes and volatility of the IFRS 9 ECL allowance. It should also be stressed that the default rates provided by external rating agencies are historical information. Entities need to understand the sources

of these historical default rates and update the data for current and forward-looking information (see section 4.9.3 above) when measuring ECLs or assessing credit deterioration.

Example 12: Use of credit ratings and/or CDS spreads to determine whether there have been significant increases in credit risk and to estimate expected credit losses

Introduction

A significant challenge in applying the IFRS 9 impairment requirements to quoted bonds is that the credit ratings assigned by agencies such as Standard & Poor's (S&P), and the historical experience of losses by rating grade, can differ significantly with the view of the market, as reflected in, for instance, credit default swap (CDS) spreads and bond spreads.

To illustrate the challenges of applying IFRS 9 to debt securities, we have examined how the ECL could be determined for a real bond issued by a European government on 16 September 2008 and due to mature in 2024. For three dates, we applied the IFRS 9 calculations to this bond, which is assumed to have been acquired at inception. In January 2009, the Standard & Poor's credit rating of the government was AA+, as at origination, but by January 2012, its rating was downgraded to A. The bond was further downgraded to BBB- in March 2014 before recovery to BBB in May 2014.

Three approaches

Shown below are three approaches:

Approach 1: Use of S&P credit ratings both to determine whether the bond has significantly increased in credit risk and to estimate ECLs.

Approach 2: Use of S&P credit ratings to determine whether the bond has significantly increased in credit risk and CDS spreads to estimate ECLs.

Approach 3: Use of CDS spreads both to determine whether the bond has significantly increased in credit risk and to estimate ECLs.

Based on the historical corporate PDs from each assessed S&P credit rating (approach 1) and based on the CDS spreads (approaches 2 and 3), the loan loss percentages were calculated below. For the calculations, an often used LGD of 60% was applied. (Because the LGD represents a percentage of the present value of the gross carrying amount, this example does not illustrate the effect of the time value of money).
The percentage loss allowances were, as follows:

	Credit ratings	Historical 12-month PD based on ratings	12-month PD based on CDS spread	Life time PD based on CDS spread	Percentage of loss allowance		
					Approach 1	Approach 2	Approach 3
1 January 2009	AA+	0.02%	0.44%	12.81%	-	-	-
31 January 2009	AA+	0.02%	1.84%	30.48%	0.01	1.10	18.29
31 January 2012	A	0.06%	4.96%	51,48%	0.04	2.98	30.89
31 March 2014	BBB-	0.31%	0.57%	23.01%	0.18	0.34	13.81

Approach 1

According to the credit ratings, the bond was investment grade throughout this period. Hence, using the low risk simplification, the loss allowance would have been based on 12-month ECLs. Using the corporate historical default rates implied by the credit ratings and an assumption of 60% LGD to calculate the ECLs, the 12-month allowance would have increased from 0.01% on 31 January 2009 to 0.04% three years later, increasing to 0.18% by 31 March 2014. It should be stressed that the historical default rates implied by credit ratings are historical rates for corporate debt and so they would not, without adjustment, satisfy the requirements of the standard.

> **Example 12: Use of credit ratings and/or CDS spreads to determine whether there have been significant increases in credit risk and to estimate expected credit losses (cont'd)**
>
> IFRS 9 requires the calculation of ECLs, based on current conditions and forecasts of future conditions, to be based on reasonable and supportable information. This is likely to include market indicators such as CDS and bond spreads, as illustrated by Approach 2.
>
> **Approach 2**
>
> In contrast to Approach 1, using credit default swap spreads to calculate the ECLs and the same assumption of 60% LGD to calculate the ECLs, the 12-month allowance would have increased from 1.1% on 31 January 2009 to 2.98% three years later, declining to 0.34% by 31 March 2014. The default rates implied by the CDSs are significantly higher than would have been expected given the ratings of these bonds. The loss allowances are, correspondingly, very much higher and very volatile. It might be argued that CDS spreads are too responsive to short-term market sentiment to calculate long-term ECLs, but it may appear difficult to find other reasonable and supportable information to adjust these rates so as to dampen the effects of market volatility.
>
> **Approach 3**
>
> Credit ratings are often viewed by the market as lagging indicators. For these bonds, the ratings are difficult to reconcile with the default probabilities as assessed by the markets. It might be argued that it is not sufficient to focus only on credit ratings when assessing whether assets are low risk since, according to CDS spreads, the bond was not low risk at any time in the period covered in this example, as it showed a significant increase in 1 year PD after inception (based on CDS spreads). The 1 year PDs increased from 0.44% on issue to 1.84% by 31 January 2009. Assessing the bond as requiring a lifetime ECL at all three dates, based on CDS spreads, would have given much higher loss allowances of 18.29%, 30.89% and 13.81%.
>
> The counter-view might be that CDS spreads are too volatile to provide a sound basis for determining significant deterioration. Perhaps the best way to make the assessment of whether a bond has increased significantly in credit risk, is to use more than one source of data and to take account of the qualitative indicators, as described in the standard.
>
> **Conclusion**
>
> The calculated ECL figures differ significantly depending on the approach taken as to how to determine a significant change in credit quality and the parameters used for the calculation. Those based on CDS spreads are both large and very volatile, reflecting the investor uncertainty during the period, when the possibility of default depended more on the political will of the European Union to maintain the integrity of the Eurozone than the economic forecasts for the particular country. As a result, the disparity between the effect of the use of credit grades and CDSs is probably more marked than for most other security investments. Nevertheless, the same challenges will be found with other securities, albeit on a smaller scale.

5.4.2 Delinquency

As already described at section 5.2.2, the standard allows use of past due information to assess whether credit risk has increased significantly, if reasonable and supportable forward-looking information (either at an individual or a collective level) is not available without undue cost or effort. This is subject to the rebuttable presumption that there has been a significant increase in credit risk if contractual payments are more than 30 days past

due.[174] Similar to the low credit risk simplification (see section 5.4.1 above), the Basel Committee guidance (see section 6.1 below) considers that sophisticated banks should not use days past due information as a primary indicator, because it is a lagging indicator, but only as a backstop measure alongside other, earlier indicators.

How we see it

Our observation of emerging practice amongst the more sophisticated banks is that they are following this regulatory guidance. In addition, it is a useful measure of the effectiveness of more forward-looking primary criteria to monitor the frequency that assets reach 30 days past due without having already been transferred to stage 2.

Given the wording in the standard, it will be interesting to see whether any less sophisticated banks will argue that they do not have, or are unable to use, more forward-looking indicators (either at an individual or a collective level) to supplement past due status.

5.4.3   12-month risk as an approximation for change in lifetime risk

In determining whether there has been a significant increase in credit risk, an entity must assess the change in the risk of default occurring over the expected life of the financial instrument. Despite this, the standard states that, '... changes in the risk of a default occurring over the next 12 months may be a reasonable approximation ... unless circumstances indicate that a lifetime assessment is necessary'.[175]

The IASB observed in its Basis for Conclusions that changes in the risk of a default occurring within the next 12 months generally should be a reasonable approximation of changes in the risk of a default occurring over the remaining life of a financial instrument and thus would not be inconsistent with the requirements. Also, some entities use a 12-month PD measure for prudential regulatory requirements and these entities can continue to use their existing systems and methodologies as a starting point for determining significant increases in credit risk, thus reducing the costs of implementation.[176]

However, for some financial instruments, or in some circumstances, the use of changes in the risk of default occurring over the next 12 months may not be appropriate to determine whether lifetime ECLs should be recognised. For a financial instrument with a maturity longer than 12 months, the standard gives the following examples:[177]

▸ The financial instrument only has significant payment obligations beyond the next 12 months

▸ Changes in relevant macroeconomic or other credit-related factors occur that are not adequately reflected in the risk of a default occurring in the next 12 months

   Or

The standard permits the use of a 12-month risk of a default occurring when determining whether credit risk has increased significantly since initial recognition, only if a change in the 12-month risk of default can be shown to be a reasonable approximation of a change in the lifetime risk.

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[174] IFRS 9 5.5.11
[175] IFRS 9.B5.5.13
[176] IFRS 9.BC5.178
[177] IFRS 9.B5.5.14

▸ Changes in credit-related factors only have an impact on the credit risk of the financial instrument (or have a more pronounced effect) beyond 12 months

On 16 September 2015, the ITG members discussed the use of changes in the 12-month risk of default as a surrogate for changes in lifetime risk and commented, as follows:

▸ An entity would be expected to complete a robust analysis up front in order to support the conclusion that changes in the 12-month risk of a default occurring was a reasonable approximation for the assessment of changes in the lifetime risk of default occurring.

▸ The level of initial analysis required would depend on the specific type of financial instrument being considered. Consequently in some cases, a qualitative analysis would suffice, whereas in less clear-cut cases, a quantitative analysis may be necessary. Also, it may be appropriate to segregate portfolios (e.g., by maturity) in order to facilitate the analysis for groups of similar financial instruments.

▸ An entity would need to be satisfied on an ongoing basis that the use of changes in the 12-month risk of a default occurring continued to be a reasonable approximation for changes in the lifetime risk of a default occurring.

At the meeting, the ITG members also discussed:

▸ The appropriate type of review that should be undertaken on an ongoing basis. While a quantitative review would not necessarily be required, it would depend on the specific facts and circumstances. One way of approaching an ongoing review would be as follows:

(a) Identify the key factors that would affect the appropriateness of using changes in the 12-month risk of a default occurring as an approximation of changes in the lifetime risk of default occurring

(b) Monitor these factors on an ongoing basis as part of a qualitative review of circumstances

(c) Consider whether any changes in those factors indicated that changes in the 12-month risk of a default occurring were no longer an appropriate proxy for changes in a lifetime risk of default occurring

▸ If it were determined that changes in the 12-month risk of a default occurring were no longer a reasonable approximation for the assessment of changes in the lifetime risk of a default occurring, an entity would be required to determine an appropriate approach to capture changes in the lifetime risk of a default occurring.

▸ It is important to emphasise that the guidance which permits an entity to use changes in the 12-month risk of a default as an approximation for the lifetime risk of default, is only relevant for the assessment of significant increases in credit risk and does *not* relate to the measurement of ECLs. When an entity is required to measure lifetime ECLs, that measurement must always reflect the lifetime risk of a default occurring.

▸ IFRS 9 does not prescribe how an entity should determine whether the use of changes in the 12-month risk of a default was an appropriate proxy for assessing changes in the lifetime risk of a default. However, it was noted that entities are required to disclose how they make the assessment of significant increases in credit risk, in accordance with IFRS 7.

How we see it

Most of the sophisticated banks currently intend to use the lifetime risk of default rather than the 12-month risk of default or the Basel risk of default for assessing whether there has been a significant increase in credit risk. Movements in a 12-month risk of default are, for most products and conditions, strongly correlated with movements in the lifetime risk. However, these banks appreciate that 12-month PDs may need to be adjusted or calibrated to reflect the longer-term macroeconomic outlook. Also, there are products such as interest-only mortgages and those with an introductory period in which no repayments are required, where additional procedures may need to be implemented in order to ensure that they are transferred to stage 2 appropriately.

5.4.4 Assessment at the counterparty level

As indicated by Example 7 in the Implementation Guidance of IFRS 9, assessment of significant deterioration in credit risk can be made at the level of the counterparty rather than the individual financial instrument. Such assessment at the counterparty level is only allowed if the outcome would not differ from the outcome if the financial instruments had been individually assessed.[178] In certain circumstances, assessment at the counterparty level would not be consistent with the impairment requirements. Both these situations are illustrated in the example below, based on Example 7 in the Implementation Guidance for the standard.[179]

> Assessment of significant deterioration in credit risk at the counterparty level is only allowed if the outcome would not be different to the outcome if the financial instruments had been individually assessed.

Example 13: Counterparty assessment of credit risk

Scenario 1

In 2011 Bank A granted a loan of $10,000 with a contractual term of 15 years to Company Q when the company had an internal credit risk rating of 4 on a scale of 1 (lowest credit risk) to 10 (highest credit risk). The risk of a default occurring increases exponentially as the credit risk rating deteriorates so, for example, the difference between credit risk rating grades 1 and 2 is smaller than the difference between credit risk rating grades 2 and 3. In 2015, when Company Q had an internal credit risk rating of 6, Bank A issued another loan to Company Q for $5,000 with a contractual term of 10 years. In 2018, Company Q fails to retain its contract with a major customer and correspondingly experiences a large decline in its revenue. Bank A considers that as a result of losing the contract, Company Q will have a significantly reduced ability to meet its loan obligations and changes its internal credit risk rating to 8.

Bank A assesses credit risk on a counterparty level for credit risk management purposes and determines that the increase in Company Q's credit risk is significant. Although Bank A did not perform an individual assessment of changes in the credit risk on each loan since its initial recognition, assessing the credit risk on a counterparty level and recognising lifetime ECLs on all loans granted to Company Q, meets the objective of the impairment requirements, as stated in paragraph 5.5.4 of IFRS 9. This is because, even since the most recent loan was originated, its credit risk has increased significantly. The counterparty assessment would therefore achieve the same result as assessing the change in credit risk for each loan individually.

Scenario 2

Bank A granted a loan of $150,000 with a contractual term of 20 years to Company X in 2011 when the company had an internal credit risk rating of 4. During 2015, economic conditions deteriorate and demand for Company X's products has declined

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[178] IFRS 9.BC5.168.
[179] IFRS 9 IG Example 7 IE43-IE47

significantly. As a result of the reduced cash flows from lower sales, Company X could not make full payment of its loan instalment to Bank A. Bank A re-assesses Company X's internal credit risk rating, and determines it to be 7 at the reporting date. Bank A considered the change in credit risk on the loan, including considering the change in the internal credit risk rating, and determines that there has been a significant increase in credit risk and recognises lifetime ECLs on the loan of $150,000.

Despite the recent downgrade of the internal credit risk rating, Bank A grants another loan of $50,000 to Company X in 2017 with a contractual term of 5 years, taking into consideration the higher credit risk at that date.

The fact that Company X's credit risk (assessed on a counterparty basis) has previously been assessed to have increased significantly, does not result in lifetime ECLs being recognised on the new loan. This is because the credit risk on the new loan has not increased significantly since the loan was initially recognised. If Bank A only assessed credit risk on a counterparty level, without considering whether the conclusion about changes in credit risk applies to all individual financial instruments provided to the same customer, the objective in paragraph 5.5.4 of IFRS 9 would not be met.

How we see it

Most banks manage their credit exposures on a counterparty basis and would be keen to use their existing risk management processes where they can. This is particularly the case for those banks that are seeking to use processes such as the use of watch lists to make the assessment. However, this will be challenging as the standard only allows use of a counterparty basis when it can be demonstrated that it would make no difference from making the assessment at an individual instrument level. It may be necessary for these banks to add procedures to track increase in the risk of default at the instrument level in order to comply with the standard.

5.4.5 Determining maximum initial credit risk for a portfolio

The IFRS 9 credit risk assessment that determines whether a financial instrument should attract a lifetime ECL allowance, or only a 12-month ECL allowance, is based on whether there has been a relative increase in credit risk. One of the challenges identified by some constituents in responding to the 2013 ED is that many credit risk systems monitor absolute levels of risk, without tracking the history of individual loans (see section 5.1 above). To help address this concern, the standard contains an approach that turns a relative system into an absolute one, by segmenting the portfolio sufficiently by loan quality at origination.

As indicated by Illustrative Example 6 in the Implementation Guidance of IFRS 9 on which Example 14 below is based, an entity can determine the maximum initial credit risk accepted for portfolios with similar credit risks on initial recognition.[180] Thereby, an entity may be able to establish an absolute threshold for recognising lifetime ECLs.

> An entity can determine the maximum initial credit risk accepted for portfolios with similar credit risks on initial recognition. Thereby, an entity may be able to establish an 'absolute' threshold for recognising lifetime expected credit losses.

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[180] IFRS 9 IG Example 6 IE40-IE42

Example 14: Comparison to maximum initial credit risk

Bank A has two portfolios of automobile loans with similar terms and conditions in Region W. Bank A's policy on financing decisions for each loan is based on an internal credit rating system that considers a customer's credit history, payment behaviour on other products with Bank A and other factors, and assigns an internal credit risk rating from 1 (lowest credit risk) to 10 (highest credit risk) to each loan on origination. The risk of a default occurring increases exponentially as the credit risk rating deteriorates so, for example, the difference between credit risk rating grades 1 and 2 is smaller than the difference between credit risk rating grades 2 and 3. Loans in Portfolio 1 were only offered to existing customers with a similar internal credit risk rating and, at initial recognition, all loans were rated 3 or 4 on the internal rating scale. Bank A determines that the maximum initial credit risk rating at initial recognition it would accept for Portfolio 1 is an internal rating of 4. Loans in Portfolio 2 were offered to customers that responded to an advertisement for automobile loans and the internal credit risk ratings of these customers range between 4 and 7 on the internal rating scale. Bank A never originates an automobile loan with an internal credit risk rating worse than 7 (i.e., with an internal rating of 8-10).

For the purposes of assessing whether there have been significant increases in credit risk, Bank A determines that all loans in Portfolio 1 had a similar initial credit risk. It determines that, given the risk of default reflected in its internal risk rating grades, a change in internal rating from 3 to 4 would not represent a significant increase in credit risk, but that there has been a significant increase in credit risk on any loan in this portfolio that has an internal rating worse than 5. This means that Bank A does not have to know the initial credit rating of each loan in the portfolio to assess the change in credit risk since initial recognition. It only has to determine whether the credit risk is worse than 5 at the reporting date to determine whether lifetime ECLs should be recognised in accordance with paragraph 5.5.3 of IFRS 9.

However, determining the maximum initial credit risk accepted at initial recognition for Portfolio 2 at an internal credit risk rating of 7, would not meet the objective of the requirements as stated in paragraph 5.5.4 of IFRS 9. This is because Bank A determines that significant increases in credit risk not only arise when credit risk increases above the level at which an entity would originate new financial assets (i.e., when the internal rating is worse than 7). Although Bank A never originates an automobile loan with an internal credit rating worse than 7, the initial credit risk on loans in Portfolio 2 is not of sufficiently similar credit risk at initial recognition to apply the approach used for Portfolio 1. This means that Bank A cannot simply compare the credit risk at the reporting date with the lowest credit quality at initial recognition (for example, by comparing the internal credit risk rating of loans in Portfolio 2 with an internal credit risk rating of 7) to determine whether credit risk has increased significantly because the initial credit quality of loans in the portfolio is too diverse. For example, if a loan initially had a credit risk rating of 4 the credit risk on the loan may have increased significantly if its internal credit risk rating changes to 6.

At its meeting on 16 September 2015, the ITG (see section1.5 above) discussed how to identify a significant increase in credit risk for a portfolio of retail loans when identical pricing and contractual terms are applied to customers across broad credit quality bands. The question was influenced by the operational simplifications described above which allows an entity to assess if there has been a significant increase in credit risk by determining the maximum initial credit risk accepted for portfolios with similar credit risks on original recognition, and by reviewing which exposures now exceed this limit. The ITG discussed an example of a retail loan portfolio (Portfolio A) comprising customers who had been assigned initial credit grades between 1 and 5 (based on a 10-grade rating scale where 1 is the highest credit quality) and had been

issued loans with the same contractual terms and pricing. The question was whether it would be appropriate to make the determination of significant increases in credit risk by using a single threshold approach such as that outlined for Portfolio 1 in Illustrative Example 6 of IFRS 9, on the basis that the exposures in Portfolio A could be considered to have a similar initial credit risk, or whether there were other more appropriate approaches such as, for example, defining a significant increase in credit risk as a specific number of notch increases in credit grade.

The ITG members observed that:

▸ When assessing whether there has been a significant increase in credit risk, it would not be appropriate for the entity to consider only factors such as pricing and contractual terms. In this regard, while the concept of economic loss was considered in developing the IFRS 9 model, the standard requires an assessment of changes in credit risk based on a wide range of factors including internal and external indicators of credit risk, changes to contractual terms, actual and expected performance/behaviours and forecasts of future conditions.

▸ Credit grading systems were not necessarily designed with the requirements of IFRS 9 in mind, and, thus, it should not be assumed that they will always be an appropriate means of identifying significant increases in credit risk. The appropriateness of using internal credit grading systems as a means of assessing changes in credit risk since initial recognition depends on whether the credit grades are reviewed with sufficient frequency, include all reasonable and supportable information and reflect the risk of default over the expected life of the financial instrument. As credit grading systems vary, care needs to be taken when referring to movements in credit grades and how this reflects an increased risk of default occurring. In addition, the assessment of whether a change in credit risk grade represents a significant increase in credit risk in accordance with IFRS 9 depends on the initial credit risk of the financial instrument being assessed. Because the relationship between credit grades and changes in the risk of default occurring differs between credit grading systems (e.g., in some cases, the changes in the risk of a default occurring may increase exponentially between grades whereas in others it may not), this requires particular consideration.

▸ Consequently, the impairment model is based on an assessment of changes in credit risk since initial recognition, rather than the identification of a specific level of credit risk at the reporting date and a smaller absolute change in the risk of default occurring will be more significant for an asset that is of high quality on initial recognition than for one that is of low quality.

▸ In Illustrative Example 6 in IFRS 9, the assessment of significant increases in credit risk of Portfolio 1 was made using a form of absolute approach. However, it was pointed out that this approach was still consistent with the objective of identifying significant increases in credit risk since initial recognition. In particular, only loans with an initial credit grade of 3 or 4 were included in Portfolio 1 and furthermore, the entity had concluded that a movement from credit grade 3 to 4 did not represent a significant increase in credit risk. Consequently, using a single threshold of credit grade 5 as a means of identifying a significant increase in credit risk since initial recognition served to capture changes in credit risk in a manner that achieved the objective of the impairment requirements.

- In contrast, in the fact pattern discussed, Portfolio A contained loans with initial credit grades ranging between 1 and 5. Questions were raised as to whether such a broad range of credit grades could be considered to represent a similar initial credit risk and the ITG members noted that, in order to conclude that the assessment could be based on whether loans had a credit rating worse than 5, the entity would need to have determined that movements between credit grades 1 and 5 did not represent a significant increase in credit risk.

- Information available at an individual financial instrument level and/or built into a credit risk grading system may not incorporate forward-looking information, as required by IFRS 9. Consequently, the assessment of significant increases in credit risk may need to be supplemented by a collective assessment to capture forward-looking information. However, a collective assessment should not obscure significant increases in credit risk at an individual financial instrument level. In this regard, portfolio segmentation is important and entities should ensure that sub-portfolios are not defined too widely.

5.5   Collective assessment

Banks have hundreds of thousands, or even millions, of small exposures to retail customers and small businesses. Much of the information available to monitor them is based on whether payments are past due and behavioural information that is mostly historical rather than forward looking. As a result such exposures tend to be managed on an aggregated basis, combining past due and behavioural data with historical statistical experience and sometimes macroeconomic indicators, such as interest rates and unemployment levels, that tend to correlate with future defaults. Also, even when exposures are managed on an individual basis, as is the case for most commercial loans, the information used to manage them may not be sufficiently forward looking to comply with the standard.

To address these concerns, the standard introduces the idea of making a collective assessment for financial assets, to determine if there has been a significant increase in credit risk, if an entity cannot make the assessment adequately on an individual instrument level. This exercise must consider comprehensive information that incorporates not only past due data but other relevant credit information, such as forward-looking macro-economic information. The objective is to approximate the result of using comprehensive credit information that incorporates forward-looking information at an individual instrument level.[181] Hence, even if a financial asset is normally managed on an individual basis, it should also be assessed collectively (i.e., based on macroeconomic indicators), if the entity does not have sufficient forward-looking information at the individual level to make the determination. The way that this might work is not very different from the IAS 39 requirement to assess an asset collectively for impairment if it has already been assessed individually and found not to be impaired.

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[181] IFRS 9.B5.5.4

How we see it

Some kind of collective adjustment or overlay will be needed for many retail lending portfolios, given that most customer-specific information will not be forward looking. In contrast, for commercial loans, the lender will typically have access to much more information and a forward-looking approach may already have been built into loan grading systems. Nevertheless, we are aware of some banks that consider that they might need to introduce an additional overlay for commercial loans so as to be more responsive to emerging macroeconomic and other risk developments. Other banks intend to achieve this by using their existing watch list approaches to supplement using their credit grading system when assessing whether there has been a significant increase in credit risk. This is because watch list systems tend to be more reactive to changing circumstances than formal credit gradings. Any one bank is likely to employ a variety of methods, depending on its products, systems and data.

> The IASB has sought to make it clear that financial assets can (and should) be assessed collectively for significant credit risk deterioration, if the entity cannot make the assessment on an individual instrument basis.

It is worth noting that the language describing when a collective approach is required is not entirely consistent within the standard. Paragraph B5.5.1 states that 'it *may be* necessary to perform the assessment' on a collective basis, which is consistent with the requirement in paragraph 5.5.11, that 'an entity cannot rely solely on past due information if reasonable and supportable forward-looking information is available without undue cost or effort'. However, paragraph B5.5.4 states that if, 'an entity does not have reasonable and supportable information that is available without undue cost or effort to measure lifetime ECLs on an individual instrument basis … lifetime credit losses *shall be* recognised on a collective basis' (emphasis added for each quotation). Banking regulators will probably ensure that this 'shall be' wording will be applied, at least for more sophisticated banks (see sections 1.6 above and 6.1 below).This raises a second concern: once significant deterioration has been identified for a portfolio, whether the entire portfolio would have to be measured using lifetime ECLs. This outcome would result in sudden, massive increases in provisions as soon as conditions begin to decline. Consequently, the Board, in finalising the standard, also had to devise a method by which only a segment or portion of the portfolio would be changed to lifetime ECLs.

Illustrative Example 5 in the Implementation Guidance for the standard illustrates how an entity may assess whether its individual assessment should be complemented with a collective one whenever the information at individual level is not sufficiently comprehensive and up-to-date. The following examples have been adapted from that guidance.

5.5.1 *Example of individual assessment of changes in credit risk*

As a benchmark, Scenario 1 (an individual assessment) illustrates a situation where a bank has sufficient information at individual exposure level to identify a significant deterioration of credit quality.

Example 15: Individual assessment in relation to responsiveness to changes in credit risk

The bank assesses each of its mortgage loans on a monthly basis by means of an automated behavioural scoring process based on current and historical past due statuses, levels of customer indebtedness, loan-to-value (LTV) measures, customer behaviour on other financial instruments with the bank, the loan size and the time since the origination of the loan. It is said that historical data indicates a strong correlation between the value of residential property and the default rates for mortgages.

> **Example 15: Individual assessment in relation to responsiveness to changes in credit risk (cont'd)**
>
> The bank updates the LTV measures on a regular basis through an automated process that re-estimates property values using recent sales in each post code area and reasonable and supportable forward-looking information that is available without undue cost or effort. Therefore, an increased risk of a default occurring due to an expected decline in residential property value adjusts the behavioural scores and the Bank is, therefore, able to identify significant increases in credit risk on individual customers before a mortgage becomes past due if there has been a deterioration in the behavioural score.
>
> The example concludes that if the bank is unable to update behavioural scores to reflect the expected declines in property prices, it would use reasonable and supportable information that is available without undue cost or effort to undertake a collective assessment to determine the loans on which there has been a significant increase in credit risk since initial recognition and recognize lifetime ECLs for those loans.

It should be noted that, in this example, the main source of forward-looking information is expected future property prices. No account would appear to be taken of other economic data, such as future levels of employment or interest rates. We assume that the Board took this approach to make the example simple, but it implies, in this particular example, that future property prices are considered to provide a sufficiently good guide to future defaults that it is not necessary to take account of other data as well.

5.5.2 Basis of aggregation for collective assessment

Next, the standard sets out how financial instruments may be grouped together in order to determine whether there has been a significant increase in credit risk. Any instruments assessed collectively must possess shared credit risk characteristics. It is not permitted to aggregate exposures that have different risks and, in so doing, obscure significant increases in risk that may arise on a sub-set of the portfolio. Examples of shared credit risk characteristics given in the standard include, but are not limited to:[182]

- ‣ Instrument type

- ‣ Credit risk ratings

- ‣ Collateral type

- ‣ Date of initial recognition

- ‣ Remaining term to maturity

- ‣ Industry

- ‣ Geographical location of the borrower

- ‣ The value of collateral relative to the asset (the loan-to-value or LTV ratio), if this would have an impact on the risk of a default occurring

The standard also states that the basis of aggregation of financial instruments to assess whether there have been changes in credit risk on a collective basis may have to change over time, as new information on groups of, or individual, financial instruments becomes available.[183]

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[182] IFRS 9.B5.5.5
[183] IFRS 9.B5.5.6

How we see it

▶ As has been stressed earlier, the assessment of significant deterioration is intended to reflect the risk of default, not the risk of loss, hence, collateral should normally be ignored for the assessment. The standard nonetheless explains that the value of collateral relative to the financial asset would be relevant to the collective assessment if it has an impact on the risk of a default occurring. It cites, as an example, non-recourse loans in certain jurisdictions. The question of when such an arrangement would always meet the IFRS 9 classification and measurement characteristics of the asset test is beyond the scope of this chapter. LTV or a house price index may be a useful indicator of significant collective deterioration in a wider range of circumstances than just where the loans are non-recourse. First, house prices are themselves a useful barometer of the economy and, so, higher LTVs and lower indices correlate with declining economic conditions. Second, loans that were originally advanced at higher LTVs may reflect more aggressive lending practices, with the consequence that such loans may exhibit a higher PD if economic conditions decline. Third, a borrower in trouble with a lower LTV will likely sell his house to redeem the mortgage rather than defaulting on the mortgage (and, conversely, a borrower with a high LTV will have less incentive not to default).

▶ By date of original recognition, we assume that the Board did not intend that loans should be assessed in separate groups for each year of origination, but that vintages may be aggregated into groups that share similar credit risk characteristics. Loan products and lending practices, including the extent of due diligence, and key ratios, such as the LTV and loan to income, change over time, often reflecting the economic conditions at the time of origination. The consequence is that loans from particular years are inherently more risky than others. For some banks, this might mean isolating those loans advanced just prior to the financial crisis from those originated earlier or in the subsequent, more careful lending environment. Also, there is a phenomenon termed seasoning, which describes how loans that been serviced adequately for a number of years, over a business cycle, are statistically less likely to default in future, suggesting that older loans should be assessed separately.

▶ Although the examples in the standard refer to regions, as the geographical location of borrowers, the groupings could be much larger, such as by country, or much smaller, if there are particular issues associated with particular towns. Hence, the choice of geographical groupings will depend very much on the environment in which a bank operates.

▶ Other ways that loans might be grouped according to shared credit risk characteristics could include by credit score, by payment history, whether previously restructured or subject to forbearance but subsequently restored to a 12-month ECL allowance, and manner of employment (as featured in Illustrative Example 5 in the Implementation Guidance for the standard under the bottom up assessment discussed in Example 16 below).

▶ The requirement that financial instruments that are assessed together must share similar credit risk characteristics means that a bank may have a substantial number of portfolios. Even a relatively small bank might have six different products (taking into account terms to maturity and types of collateral), three regions and three different vintage groups

which, multiplied out, would give fifty four different assessment groups. A larger, global bank might need to monitor many more different portfolios. However, a balance will need to be struck between ensuring that portfolios are small enough to have sufficient homogeneity and yet not so small that there is too little historical data for losses to be reliably estimated.

▶ Also, the requirement that groupings may have to be amended over time means that there must processes to reassess whether loans continue to share similar credit risk characteristics. Yet, in practice, there will need to be a sufficient level of stability in the construction of portfolios to allow enough historical data to be gathered for reliable estimation of losses.

Finally, paragraph B5.5.6 of IFRS 9 adds that, 'if an entity is not able to group financial instruments for which the credit risk is considered to have increased significantly since original recognition based on shared credit risk characteristics, the entity should recognise lifetime ECLs on a portion of the financial assets for which credit risk is deemed to have increased significantly'.

As clarified by the IASB in its webcast on forward-looking information in July 2106, it is possible that a bank is aware of differences in sensitivities of credit risk to a change in a particular parameter, but is unable to group the assets on the basis of such sensitivity. In such instances, the bank may determine that the expected forward-looking scenario would result in significant increases in credit risk for a certain proportion of its portfolio.

5.5.3 *Example of collective assessment ('bottom up' and 'top down' approach)*

The main standard does not amplify how a collective assessment would be made, but Illustrative Example 5 in the Implementation Guidance of IFRS 9 provides two scenarios that explore the approach.[184]

Example 16: Collective assessment in relation to responsiveness to changes in credit risk ('bottom up' approach)

Region Two of Illustrative Example 5 in the Implementation Guidance for the standard introduces the so-called bottom up method. It deals with a mining community within a region that faces unemployment risk due to a decline in coal exports and, consequently, anticipated future mine closures. Although most of the loans are not yet 30 days past due and, further, the borrowers are not yet unemployed, the bank re-segments its mortgage portfolio so as to separate loans to customers employed in the mining industry (based on information in the original mortgage application form). For these loans (plus any others that are more than 30 days past due), Bank ABC recognises lifetime ECLs, while it continues to recognise 12-month ECLs for the other mortgage loans in the region. Any new loans to borrowers who rely on the coal industry would also attract only a 12-month allowance, until they also demonstrate a significant increase in credit risk.

The bottom up method is described as an example of how to assess credit deterioration by using information that is more forward-looking than past due status. But this example also illustrates that collectively assessed groups may need to change over time, to ensure that they share similar credit risk characteristics. Once the coal mining industry begins to decline, those loans connected with it would no longer share the same risk characteristics as other

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[184] IFRS 9 IG Example 5 IE29-IE39.

loans to borrowers in the region, and so would need to be assessed separately. We also note that this example assumes that macroeconomic factors can be linked to the ECLs of a very specific portfolio. Further, in practice, most banks may not have the data to achieve this level of segmentation.

As already described above (possible criteria for grouping of financial assets with similar credit risk characteristics), the bottom up approach could be applied to sub-portfolios differentiated by type of instrument, risk rating, type of collateral, date of initial recognition, remaining term to maturity, industry, geographical location of the borrower, or the LTV ratio. A good example of this approach might be for exposures to borrowers that are expected to suffer major economic difficulties due to war or political upheaval, or borrowers with the weakest credit scores, who are expected to be more sensitive to a change in a relevant macroeconomic factor. In addition, as underwriting standards may vary or change, the portfolio might be sub-divided so as to reflect this. Note that the coal mines closures are, as yet, only anticipated, hence, this example helps show how the standard is intended to look much further forward than the consequent unemployment that would probably trigger an IAS 39 impairment provision. The need to look forward is also illustrated in the next example.

Example 17: Collective assessment in relation to responsiveness to changes in credit risk ('top down' approach)

For Region Three of Illustrative Example 5 in the Implementation Guidance for the standard, Bank ABC anticipates an increase in defaults following an expected rise in interest rates. We are told that, historically, an increase in interest rates has been a lead indicator of future defaults on floating-rate mortgages in the region. The bank regards the portfolio of variable rate mortgage loans in that region to be homogenous and it is incapable of identifying particular sub portfolios on the basis of shared credit risk characteristics. Hence, it uses what is described as a top down method.

Based on historical data, the bank estimates that a 200 basis points rise in interest rates will cause a significant increase in credit risk on 20 per cent of the mortgages. As a result, presumably because the bank expects a 200 basis points rise in rates, it recognises lifetime ECLs on 20 per cent of the portfolio (along with those loans that are more than 30 days past due) and 12-month ECLs on the remainder of mortgages in the region.

The challenge posed by the top down method is how to calculate the percentage of loans that have significantly deteriorated. That a rise in interest rates will likely lead to a significant deterioration in credit risk for some floating-rate borrowers, is not controversial. But working out whether the proportion of significantly affected borrowers makes up 5 per cent, 20 per cent or 35 per cent of the portfolio would appear to be more of an art than science, and no two banks are likely to arrive at the same figure.

The IASB brought some useful clarification on this example in its July 2016 webcast on forward-looking information:

‣ First, it clarified that one financial instrument cannot exist in stage 1 and in stage 2 at the same time. Therefore, the Board in the above example did not mean that each asset in the portfolio is to be regarded as 20% in stage 2 and 80% in stage 1. Instead, 20% of the assets are in stage 2, even if the bank does not yet know which.

‣ This allocation is intended to reflect that some assets in the portfolio will respond more adversely to a given change to the macroeconomic factor (e.g., unemployment rate) than others. Therefore, some assets

in the portfolio may be considered to have significantly increased in credit risk while others have not. Judgment is required to determine how much of the portfolio should move to stage 2. An entity may, for example, determine that given the range of possible scenarios, 20% of the portfolio moves to stage 2 considering the different level of sensitivity of the assets in the portfolio to the different relevant credit risk drivers.

▸ As further explained in the next section on using multiple scenarios for the staging assessment (see section 5.7 below), it is important to note that the 20% is not the probability of occurrence of the more adverse scenario. Rather, it reflects the proportion of the portfolio deemed to have already significantly deteriorated based on the most recent probability-weighted average PD. This is due to the heightened sensitivity of this proportion of the portfolio to certain macroeconomic factors.

A further issue with the top down approach is the question of what the lender should do if it subsequently finds that differences in risk characteristics emerge within the portfolio, such that certain assets need to be measured using lifetime ECLs using the bottom up approach. A similar question arises if individual assets subsequently need to be measured using lifetime ECLs, for instance, because they become 30 days past due. In practice, it is likely that banks, at each reporting date, will first allocate exposures to stage 2 based on an individual assessment and then apply a collective approach to the remaining stage 1 exposures. They are unlikely to 'roll-forward' the collective allowance.

Presumably the proportion of the portfolio ECLs in stage 2 can be measured once again using 12-month ECLs if economic conditions are expected to improve. However, any assets that are 30 days past due will continue to be treated as stage 2.[185]

How we see it

Because of these and similar difficulties, we are not currently aware of any banks who intend to use the top down approach in the manner set out in the Illustrative Example. Banks prefer to know which loans are measured using lifetime ECLs, rather than a notional percentage of the population. In practice, the methods that are being explored by banks are closer to a mixture of the bottom up and top down approaches, as described in Examples 16 and 17 above. Macroeconomic indicators are assessed, as in the top down approach, but the effect is determined by assessing the effect on particular exposures. One possible method is to determine the expected migration of loans through a bank's risk classification system, by recalibrating the probabilities of default based on forward-looking data. This could be used to forecast how many additional loans will get downgraded as well as the associated ECLs. Another is to focus on more vulnerable categories of lending, such as interest-only mortgages, secured loans with high loan-to-value ratios, or property development loans, and assess how these might respond to the economic outlook. The more information about customers that a lender possesses, the more this might look like the illustrated bottom up approach. It is likely that banks will use different approaches for different portfolios, depending on how they are managed and what data is available.

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[185] IFRS 9.B5.5.19

All of the examples in the illustrative examples simplify the fact pattern to focus on just one driver of credit losses, whereas in reality there will be many, and it may not be possible to find a historical precedent for the combination of economic indicators that may now be present. Further, to delve into the past to predict the future requires a level of data that banks may lack. The example in the standard bases the percentage on historical experience, but it is more than 20 years since most developed countries last saw a 200 basis points rise in interest rates, and products and lending practices were then very different, as was the level of interest rates before they began to rise and the extent of the increase. Hence, the past may not be a reliable guide to the future. In practice, banks will need to determine the main macroeconomic variables that correlate with credit losses and focus on modelling these key drivers of loss. The banks can make use of work that has already been carried out for stress testing. Also, it should be stressed that banks will generally use one single model to estimate forward-looking PDs for both for the assessment of significant increases in credit risk and the measurement of ECLs (see section 4.9.3 above).

The example of an anticipated increase in interest rates is very topical, given that rates in many countries are expected to rise in future from the all-time low levels that have been experienced since the financial crisis. This gives rise to an observation that is relevant to any ECL model: banks and (hopefully) borrowers have presumably known that new variable loans made since the crisis would likely increase in rate as the economy improves. If the increase was anticipated at the time of origination, expectation of a rise in interest rate should not be viewed as a significant deterioration in credit risk. Yet, there is a concern that rising rates will bring difficulty for many borrowers who have over stretched themselves, implying that the inevitable rise was not fully factored into lending decisions. With any forward-looking approach it is necessary to understand what risks were already taken into account when loans are first made, to assess whether there has been a significant increase in risk.

5.6 Determining the credit risk at initial recognition of an identical group of financial assets

In practice, entities may hold a portfolio of debt securities that are identical and cannot be distinguished individually (e.g., all securities have the same international securities identification number (ISIN)) and over the lifetime of the portfolio, entities may acquire additional securities or sell some of those previously acquired. In such instances, entities have to determine the credit risk at initial recognition of those securities that remain in the homogeneous portfolio at the reporting date.

IFRS 9 contains no specific guidance on how to calculate the cost of financial assets for derecognition purposes when they are part of a homogenous portfolio. Under IAS 39, which is also silent on this topic, entities choose between the following cost allocation methods for available-for-sale securities: the average cost method, the first-in-first-out (FIFO) method or the specific identification method. Specific identification can be applied if the entity is able to identify the specific items sold and their costs. For example, a specific security may be identified as sold by linking the date, amount and cost of securities bought with the sale transaction, provided that there is no other evidence suggesting that the actual security sold was not the one identified under this method.

For IFRS 9, the question arises whether entities can continue to apply one of the above methods for debt instruments, not only for determining the cost of the security at derecognition, but also for determining their initial credit risk. We believe that:

‣ The method used for recognising and measuring impairment losses should normally be the same as that used for determining the cost allocation method on derecognition.

‣ Either a FIFO approach or a specific identification method, as described above, constitute acceptable accounting policy choices to be applied consistently.

‣ However, it would not normally be appropriate to use the weighted-average method to determine the credit risk at initial recognition, as averaging the different levels of initial credit risk of debt securities purchased at different dates would result in an identical initial credit risk for each item. It, therefore, would create bias when assessing whether the credit risk of debt securities has increased significantly.

5.7 Multiple scenarios for the assessment of significant increases in credit risk

At its December 2015 meeting, the ITG discussed not only the need to consider multiple scenarios for the measurement of ECLs (see section 4.6 above), but also for the purposes of assessing whether exposures should be measured on a lifetime loss basis.

Similar to the measurement of ECLs, the ITG members noted that where there is a non-linear relationship between the different forward looking scenarios and the associated risks of default, using a single scenario would not meet the objectives of the standard. Consequently, in such cases, an entity would need to consider more than one forward looking scenario. Further, there should be consistency, to the extent relevant, between the information used to measure ECLs and that used to assess significant increases in credit risk. An example of when the information might not be relevant is the value of collateral. It may be necessary to calculate the effect of multiple scenarios to value collateral to measure ECLs, but this information may not be relevant to assessing significant changes in credit risk unless the value has an effect on the probability of default occurring.[186]

As with the measurement of ECLs, the ITG members noted that IFRS 9 does not prescribe particular methods of assessing for significant increases in credit risk. Consequently, various methods could be applied, depending on facts and circumstances and these may include both quantitative and qualitative approaches. An entity should not restrict itself by considering only quantitative approaches when deciding how to incorporate multiple forward-looking scenarios. Whichever approach is taken, it should be consistent with IFRS 9, considering reasonable and supportable information that is available without undue cost and effort. Once again, this is an area of judgement and, so, appropriate disclosures would need to be provided to comply with the requirements of IFRS 7 (see section 14 below).

A further issue was raised at the ITG meeting, which was not referred to in the minutes, but was addressed in the 25 July 2016 IASB webcast. If a number of scenarios are applied to an individual asset, in some of which, there is no significant increase in credit risk and in others there is, is it possible that

> Where there is a material non-linear relationship between different macroeconomic scenarios and the risk of default, it is necessary, to consider multiple scenarios for the staging analysis.

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[186] IASB Transition Resource Group for Impairment of Financial Instruments, Meeting Summary, Paragraphs 58 and 59, 11 December 2015.

it could be measured partly based on 12 month losses and partly on lifetime losses? It was not the intention of the IASB that an asset should be regarded as being in more than one stage at the same time. For staging as well as for measurement, IFRS 9 applies to the unit of account, which is the individual financial instrument. The financial asset cannot be considered to have partly significantly deteriorated and partly not. Hence, for instance, if the staging assessment is based on a mechanistic approach which considers the change in the lifetime probability of default, the entity should use the multiple scenario probability-weighted lifetime probability of default to assess whether there has been a significant increase in credit risk. The asset should then be measured using the weighted 12-month probability of default if it is considered to be in stage 1, or the weighted lifetime probability of default if it is considered to be in stage 2.

However, as described in section 5.5.3 above, the webcast also noted that, for a collectively assessed portfolio of assets, a proportion of the portfolio only may be deemed to have significantly deteriorated while the rest of the portfolio has not, due to differences in sensitivities of credit risk to a change in a particular parameter.

The IASB also illustrated how multiple scenarios can be reflected in a non-PD-based approach, using the example of a scorecard system. If the entity determines that there is non-linearity in the effect of the scenarios on the credit risk of the customers, one possibility is to look at the scorecard inputs and to determine which of these inputs have a non-linear relationship with the macroeconomic parameters. The entity then adjusts the scorecard, for example, using a scaling factor to reflect the impact of non-linearity, assesses whether there has been a significant increase in credit risk and measures ECL on the basis of the adjusted scorecard.

The approach set out in this discussion is broadly the same as 'the top down' approach to collective assessments illustrated by Example 17.

It is important to note that the ITG did not state that it is always necessary to use multiple scenarios and probability-weighted lifetime probabilities of default to assess significant increases in credit risk.

What it did state is that:

▸ It is necessary to consider more than one scenario if there is non-linearity in the possible distribution of losses

▸ Qualitative approaches may be included as well as quantitative ones, so that, for instance, it might be possible to take account of non-linearities by scaling the output from score cards

▸ The assessment should be based on reasonable and supportable information that is available without undue cost or effort (see section 4.9.1 above)

Nevertheless, the ITG did state that there should be consistency, to the extent relevant, between the forward-looking information used for measurement and for the assessment of significant increases in credit risk. There would not always be a direct mapping of the relevant information, because, in some cases, information might have an impact on the measurement of ECLs but not on the assessment of significant increases in credit risk (and *vice versa*). Also, various methods of assessing for significant increases in credit risk could be applied, depending on the particular facts and circumstances, and an entity should not restrict itself by considering only quantitative approaches when considering how to incorporate multiple forward-looking scenarios.

In the July 2016 webcast, the IASB also stressed the importance of adequate disclosures. Because there is no one right approach and because this area involves a high level of judgement, disclosures are very important to enable users of financial statements to understand how entities' credit risk is affected by forward-looking scenarios and how they have affected the application of the ECL model. It would also be useful to disclose if relevant forward looking information has not been reflected in the assessment of significant deterioration on the basis that it is not reasonable and supportable.

In practice, many banks that use multiple scenarios of lifetime probabilities of default to measure assets in stage 2, also intend to use them for assessing if there has been a significant increase in credit risk. Moreover, as with measurement, banks will need to consider regulators' expectations (see section 6.1 below).

6 Other matters and issues in relation to the expected credit loss calculations

This section discusses other matters and issues that are relevant to applying the IFRS 9 impairment requirements.

6.1 Basel guidance on accounting for expected credit losses

In December 2015, the Basel Committee published the final version of its *Guidance on Credit Risk and Accounting for Expected Credit Losses* (sometimes referred to as 'G-CRAECL', but in this publication, as 'the Basel guidance' or just 'the guidance') (see section 1.6 above). The guidance deals with lending exposures, and not debt securities, and does not address the consequent capital requirements.

The guidance was originally drafted for internationally active banks and more sophisticated banks in the business of lending. The final version does not limit its scope but allows less complex banks to apply, 'a proportionate approach' that is commensurate with the size, nature and complexity of their lending exposures. It also extends this notion to individual portfolios of more complex banks. It follows that determining what is proportionate will be a key judgement to be made, which is likely to be guided in some jurisdictions by banking regulators. The guidance issued in June 2016 by the GPPC (see section 6.2 below) will also be relevant in making this determination. The final version of the guidance acknowledges that due consideration may also be given to materiality.

The Basel Committee guidance is designed for internationally active banks, but is intended to be applied by all banks using 'a proportionate approach'.

The main section of the Basel Committee's guidance is intended to be applicable in all jurisdictions (i.e., for banks reporting under US GAAP as well as for banks reporting under IFRS) and contains 11 supervisory principles. The guidance is supplemented by an appendix that outlines additional supervisory requirements specific to jurisdictions applying the IFRS 9 ECL model.

It is important to stress that the guidance is not intended to conflict with IFRS 9 (and, indeed, this has been confirmed by the IASB), but it goes further than IFRS 9 and, in particular, removes some of the simplifications that are available in the standard. It also insists that any approximation to what would be regarded as an 'ideal' implementation of ECL accounting should be designed and implemented so as to avoid 'bias'. The term 'avoidance of bias' is used several times in the guidance and we understand it to have its normal accounting meaning of neutrality. Hence, for instance, if a bank were ever dependent on past-due information to assess whether an exposure should be measured on a lifetime ECL basis, it is guided to 'pay particular attention

to its measurement of the 12-month allowance to ensure that ECLs are appropriately captured in accordance with the measurement objective of IFRS 9.'[187]

Perhaps one of the most significant pieces of guidance provided by the Basel Committee relates to the important requirement in IFRS 9 that ECLs should be measured using 'reasonable and supportable information'. The Committee accepts that in certain circumstances, information relevant to the assessment and measurement of credit risk may not be reasonable and supportable and should therefore be excluded from the ECL assessment and measurement process. But, given that credit risk management is a core competence of banks, 'these circumstances would be exceptional in nature'.[188] This attitude pervades the guidance. It also states that management is expected 'to apply its credit judgement to consider future scenarios' and '[t]he Committee does not view the unbiased consideration of forward looking information as speculative'.[189] The guidance, therefore, establishes a high hurdle for when it is not possible for an internationally active bank to estimate the effects of forward looking information. It is possible that banking regulators would expect banks to make an estimate of the effects of events with an uncertain binary outcome that is highly significant, such as the result of a referendum as discussed by the ITG in September 2015 (see 4.9.3 above).

A connected piece of the guidance relates to another important principle in IFRS 9, that reasonable and supportable information should be available 'without undue cost or effort'. The guidance states that banks are not expected to read this 'restrictively'. It goes on to say that, 'Since the objective of the IFRS 9 model is to deliver fundamental improvements in the measurement of credit losses … this will potentially require costly upfront investment in new systems and processes'. Such costs 'should therefore not be considered undue'.[190]

Much of the guidance relates to systems and controls and so is outside the scope of this publication. The requirements of the main section that relate to accounting include:

‣ There should be commonality in the processes, systems, tools and data used to assess credit risk and to measure ECLs for accounting and for regulatory capital purposes.[191]

‣ When a bank's individual assessment of exposures does not adequately consider forward-looking information, it is appropriate to group lending exposures with shared credit risk characteristics to estimate the impact of forward-looking information, including macroeconomic factors (see 5.5 above).[192] The grouping of lending exposures into portfolios with shared credit risk characteristics must be re-evaluated regularly (including re-segmentation in light of relevant new information or changes in the bank's

[187] Basel Committee on Banking Supervision, *Guidance on credit risk and accounting for expected credit losses*, Paragraph A55, December 2015.

[188] Basel Committee on Banking Supervision, *Guidance on credit risk and accounting for expected credit losses*, Paragraph 22, December 2015.

[189] Basel Committee on Banking Supervision, *Guidance on credit risk and accounting for expected credit losses*, Paragraph 21, December 2015.

[190] Basel Committee on Banking Supervision, *Guidance on credit risk and accounting for expected credit losses*, Paragraph A47, December 2015.

[191] Basel Committee on Banking Supervision, *Guidance on credit risk and accounting for expected credit losses*, Paragraph 69, December 2015.

[192] Basel Committee on Banking Supervision, *Guidance on credit risk and accounting for expected credit losses*, Paragraph 57, December 2015.

expectations). Groupings must be granular enough to assess changes in credit risk and changes in a part of the portfolio must not be masked by the performance of the portfolio as a whole.[193]

▸ 'Adjustments' may be used to address events, circumstances or risk factors that are not fully considered in credit rating and modelling processes. But the Committee expects that such adjustments will be temporary. If the reason for an adjustment is not expected to be temporary then the processes should be updated to incorporate that risk driver. The guidance goes on to say that adjustments require judgement and create the potential for bias. Therefore, they should be subject to appropriate governance processes.[194]

▸ The 'consideration of forward-looking information and macroeconomic factors is considered essential to the proper implementation of an ECL model. It cannot be avoided on the basis that the banks consider the costs to be excessive or unnecessary or because there is uncertainty in formulating forward looking scenarios'. However, the Committee recognises that an ECL is 'an estimate and thus may not perfectly predict actual outcomes. Accordingly, the need to incorporate such information is likely to increase the inherent degree of subjectivity in ECL estimates, compared with impairment measured using incurred loss approaches'. Also, the Basel Committee recognises that it may not always be possible to demonstrate a strong link in formal statistical terms between certain types of information and the credit risk drivers. Consequently, a bank's experienced credit judgement will be crucial in establishing the appropriate level for the individual or collective allowance.[195]

▸ Although the final version of the guidance notes less about disclosures than the draft version, given the publication of the Enhanced Disclosure Task Force (EDTF) recommendations, disclosure remains one of the key principles (see 14 below).

The guidance is supplemented by an appendix that outlines additional supervisory requirements specific to jurisdictions applying the IFRS 9 ECL model. The key requirements are outlined below:

▸ A bank's definition of default adopted for accounting purposes should be guided by the definition used for regulatory purposes, which includes both a qualitative 'unlikeliness to pay' criterion and an objective 90-days-past-due criterion, described by the Committee as a 'backstop'.

▸ The IFRS 9 requirement to assess whether exposures have significantly increased in credit risk 'is demanding in its requirements for data, analysis and use of experienced credit judgement'. The determination should be made 'on a timely and holistic basis', considering a wide range of current information. It is critical that banks have processes in place to ensure that financial instruments, whether assessed individually or collectively, are moved from the 12-month to the lifetime ECL measurement as soon as credit risk has increased significantly. Credit losses very often begin to deteriorate a considerable period of time before an actual delinquency occurs and delinquency data are generally backward-looking. Therefore, 'the Committee believes that they will seldom on their own be appropriate

> Delinquency data alone will seldom be sufficient to inform a bank's staging assessment.

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[193] Basel Committee on Banking Supervision, *Guidance on credit risk and accounting for expected credit losses*, Paragraphs 46 - 49, December 2015.

[194] Basel Committee on Banking Supervision, *Guidance on credit risk and accounting for expected credit losses*, Paragraphs 50, 51 and 58, December 2015.

[195] Basel Committee on Banking Supervision, *Guidance on credit risk and accounting for expected credit losses*, Paragraphs 64 and 65, December 2015.

in the implementation of an ECL approach by a bank.' Instead, banks need to consider the linkages between macroeconomic factors and borrower attributes, using historical information to identify the main risk drivers, and current and forecast conditions and experienced credit judgement to determine loss expectations. This will apply not only to collective assessments of portfolios, but also for assessments of individual loans. The guidance gives the example of a commercial property loan, for which the bank should assess the sensitivity of the property market to the macroeconomic environment and use information such as interest rates or vacancy rates to make the assessment.[196]

‣ In assessing whether there has been a significant increase in credit risk, banks should not rely solely on quantitative analysis. The guidance draws banks' attention to the list of qualitative indicators set out in paragraph B5.5.17 of the standard. Particular consideration should be given to a list of conditions, including an increased credit spread for a particular loan, a decision to strengthen collateral and/or covenant requirements, a downgrade by a credit rating agency or within the bank's internal credit rating system, a deterioration in future cash flows, or an expectation of forbearance or restructuring Also, the guidance stresses that the sensitivity of the risk of a default occurring to rating downgrades increases strongly as rating quality declines. Therefore, the widths of credit risk grades need to be set appropriately, so that significant increases in credit risk are not masked. Further, 'if a decision is made to intensify the monitoring of a borrower or class of borrowers, it is unlikely that such action would have been taken ... had the increase in credit risk not been perceived as significant.[197]

‣ Exposures that are transferred to stage 2 and that are subsequently renegotiated or modified, but not derecognised, should not be moved back to stage 1 until there is sufficient evidence that the credit risk over the remaining life is no longer significantly higher than on initial recognition. 'Typically, a customer would need to demonstrate consistently good payment behaviour over a period of time before the credit risk is considered to have decreased.[198]

‣ IFRS 9 includes a number of practical expedients (see section 5.4 above). However, as banks are in the business of lending and it is unlikely that obtaining relevant information will involve undue cost or effort, the Basel Committee expects their limited use by internationally active banks. For instance:

  ‣ The long-term benefit of a high-quality implementation of an ECL model that takes into account all reasonable and supportable information far outweighs the associated costs.

  ‣ The use of the low credit risk simplification is considered a low-quality implementation of the ECL model and its use should be limited (except for holdings in debt securities, which are out of scope of the guidance). Also, the reference to an investment grade rating in the standard is only given as an example of a low credit risk exposure. An investment grade rating given by a rating agenda

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[196] Basel Committee on Banking Supervision, *Guidance on credit risk and accounting for expected credit losses*, Paragraphs A15 to A21, December 2015.

[197] Basel Committee on Banking Supervision, *Guidance on credit risk and accounting for expected credit losses*, Paragraphs A23 to A30, December 2015.

[198] Basel Committee on Banking Supervision, *Guidance on credit risk and accounting for expected credit losses*, Paragraphs A44, December 2015.

cannot automatically be considered low credit risk because banks are expected to rely primarily on their own credit assessments.

‣ Delinquency is a lagging indicator. Therefore, the Committee does not expect banks not to use the more-than-30-days-past-due rebuttable presumption as a primary indicator of a significant increase in credit risk. Banks may only use the rebuttable presumption as a backstop measure, alongside other earlier indicators, while any rebuttal of the presumption would have to be accompanied by a thorough analysis to show that 30 days past due is not correlated with a significant increase in credit risk.[199]

6.2   Global Public Policy Committee (GPPC) guidance

On 17 June 2016, the GPPC published *The implementation of IFRS 9 impairment by banks* – *Considerations for those charged with governance of systemically important banks* (the GPPC guidance). The GPPC is the Global Public Policy Committee of representatives of the six largest accounting networks. This publication was issued to promote the high-quality implementation of the accounting for ECLs in accordance with IFRS and to help those charged with governance to identify the elements of a high-quality implementation. It was designed to complement other guidance such as that issued by the Basel Committee (see 6.1 above) and the EDTF (see section 14). It does not purport to amend or interpret the requirements of IFRS 9 in any way. The first half of the GPCC guidance sets out key areas of focus for those charged with governance. This includes governance and controls, transition issues and ten questions that those charged with governance might wish to discuss. The second half of the guidance sets out a sophisticated approach to implementing each aspect of the requirements of IFRS 9, along with considerations for a simpler approach and actions that would not be compliant. Where relevant to understanding the accounting requirements of IFRS 9, this guidance is reflected in this chapter.

The GPPC guidance regards determination of the level of sophistication of the approach to be used as one of the key areas of focus for those charged with governance. Consequently, it provides guidance on how to make this determination for particular portfolios. It sets out factors to consider at the level of the entity, such as the extent of systemic risk that the bank poses, whether it is listed or a public interest entity, the size of the balance sheet and off-balance sheet credit exposures, and the level and volatility of historical credit losses. Portfolio-level factors include the entity's size relative to the total balance sheet and its complexity, the sophistication of other lending-related modelling methodologies, the extent of available data, the level of historical losses and the level and volatility of losses expected in the future. The document stresses that a simpler approach is not necessarily a lower quality approach if it is applied to an appropriate portfolio.

Also, on 28 July 2017, the GPPC issued a second paper, *The Auditor's Response to the Risks of Material Misstatement Posed by Estimates of Expected Credit Losses under IFRS 9*. This paper was written in an effort to assist audit committees in their oversight of the bank's auditors with regard to auditing ECLs. It is addressed primarily to the audit committees of systemically-important banks (SIBs) because of the relative importance of SIBs to capital markets and global financial stability but it relevant for other banks as well. It should be read in conjunction with the initial guidance published in 2016.

<div style="background:yellow">The GPPC guidance aims to help those charged with governance to identify the elements of a high-quality implementation of IFRS 9.</div>

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[199]   Basel Committee on Banking Supervision, *Guidance on credit risk and accounting for expected credit losses*, Paragraphs A45 to A55, December 2015.

6.3 Measurement dates of expected credit losses

6.3.1 Date of derecognition and date of initial recognition

Impairment must be assessed and measured at the reporting date. IFRS 9 also requires a derecognition gain or loss to be measured relative to the carrying amount at the date of derecognition. This necessitates an assessment and measurement of ECLs for that particular asset as at the date of derecognition, as was confirmed by the discussions at the April 2015 ITG meeting. Essentially, the calculation of derecognition gains or losses is a two-step process:

▸ Step 1: ECLs are remeasured at the date of derecognition and presented in the separate impairment line item in the statement of profit or loss, as per paragraph 82(ba) of IAS 1 *Presentation of Financial Statements*. As mentioned at 4.8.2 above, if the asset is impaired and the sale of the asset is one of the possible methods of recovery, this scenario should be included in measuring ECLs. Otherwise, even if the financial asset is about to be sold, the change in ECL estimate should still reflect the reporting entity's view rather than the market's view of credit losses based upon the remaining contractual life of the financial asset. Also, the residual life of the asset should not be deemed to be nil because of the imminent sale and impairment losses that have not materialised should not be mechanically reversed to reflect the fact that the reporting entity will no longer be holding the debt security. This is consistent with examples 13 and 14 of IFRS 9. In particular, a footnote to the last journal entry in example 14 explains that the loss on sale includes the accumulated impairment amount.

▸ Step 2: Gains or losses on derecognition are calculated taking into account all ECLs for financial assets measured at amortised cost and all cumulative gains or losses previously recognised in other comprehensive income including those related to ECLs for financial assets measured at fair value through other comprehensive income. Unlike the requirement to present gains and losses arising from the derecognition of financial assets measured at amortised cost as a separate line item in the statement of profit or loss as per paragraph 82(aa) of IAS 1, there is no specific presentation requirement for financial assets measured at fair value through other comprehensive income.

A similar issue is whether impairment needs to be measured at the date that an asset is modified (see section 7 below).

At the April 2015 meeting, the ITG also discussed a more difficult question, whether impairment must be measured as at the date of initial recognition for foreign currency monetary assets. The significance of this is whether subsequent gains and losses arising from foreign currency retranslation in the first accounting period should be calculated based on the initial gross amortised cost or a net amount, after deducting an impairment allowance. This would affect the allocation of subsequent gains and losses of the asset in this period to impairment or to foreign currency retranslation, so that it would be reported in different lines of the profit or loss account.

Differing views were expressed:

▸ A few ITG members supported the view that while IFRS 9 does not expressly require ECLs to be measured at the date of initial recognition, the requirements of other IFRSs, e.g., IAS 21, may result in an entity measuring ECLs at the date of initial recognition. Also, Illustrative Example 14 in IFRS 9 implies the need to include ECLs on initial recognition in the measurement of foreign exchange gains and losses in respect of a foreign currency-denominated asset (see Example 20 in section 8.2

below). However, these members questioned the frequency with which an entity needed to perform that calculation and pointed out that considerations of materiality would be a key factor in making this decision.

▸ Some other ITG members were of the view that an entity is required to measure a financial asset at its fair value upon initial recognition and that consequently measuring ECLs at initial recognition would be inconsistent with that requirement.[200] IFRS 9 includes impairment as part of the subsequent measurement of a financial asset and, as such, only requires an entity to begin measuring ECLs at the first reporting date after initial recognition (or on derecognition if that occurs earlier).[201] While the requirements of other IFRSs should be applied to the loss allowance at that point, the application of those requirements should not result in an entity having to measure ECLs at a date earlier than that specifically required by IFRS 9.

The ITG also noted that the illustrative examples are non-authoritative and illustrate only one way of applying the requirements of IFRS 9. Measuring a 12-month expected loss using point in time, forward-looking information, every time that a foreign currency exposure is first recognised would not be feasible. Given that there was no consensus on this issue, we expect that there may be diversity in practice.

6.3.2   Trade date and settlement date accounting

For financial assets measured at amortised cost or at fair value through other comprehensive income, IFRS 9 requires entities to use the trade date as the date of initial recognition for the purposes of applying the impairment requirements.[202] This means that entities that use settlement date accounting for regular way purchases of debt securities may have to recognise a loss allowance for securities which they have purchased but not yet recognised, and, correspondingly, no loss allowance for securities that they have sold but not yet derecognised.

Irrespective of the accounting policy choice for trade date accounting versus settlement date accounting, the recognition of the loss allowance on the trade date ensures that entities recognise the loss allowance at the same time; otherwise entities could choose settlement date accounting to delay recognising the loss allowance until the settlement date. The effect of this is similar to accounting for fair value changes for financial assets measured at fair value through other comprehensive income and those measured at fair value through profit or loss when settlement date accounting is applied (i.e., a measurement change needs to be recognised in profit or loss and the statement of financial position, even if the related assets that are being measured are only recognised slightly later). It is also consistent with the treatment of ECLs in loans, where an ECL is calculated in respect of a loan commitment between the date that the commitment is made and the loan is drawn down.

For settlement date accounting, the recognition of a loss allowance for an asset that has not yet been recognised raises the question of how that loss allowance should be presented in the statement of financial position. The time between the trade date and the settlement date is somewhat similar to a loan commitment in that the accounting is off balance sheet, which suggests presentation of the loss allowance as a provision.

In practice, some entities tend to opt for settlement date accounting for regular way securities recorded at amortised cost, because they do not

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[200] IFRS 9.5.1.1
[201] IFRS 9.3.2.12, 9.5.5.3, 9.5.5.5, 9.5.5.13
[202] IFRS 9.5.7.4

need the additional systems capabilities to account for the securities on trade date (i.e., they do not need to account for them until the settlement date). The change from the IAS 39 incurred loss model to the IFRS 9 ECL model means that the settlement date accounting simplification for financial assets measured at amortised cost would lose much of its benefit from an operational perspective.

6.4 Interaction between the initial measurement of debt instruments acquired in a business combination and the impairment model of IFRS 9

Consistent with IFRS 9 and IFRS 13, IFRS 3 *Business Combinations* requires financial assets acquired in a business combination to be measured by the acquirer on initial recognition at their fair value.[203] IFRS 3 contains application guidance explaining that an acquirer should not recognise a separate valuation allowance (i.e., loss allowance for ECLs) in respect of loans and receivables acquired in a business combination for contractual cash flows that are deemed to be uncollectible at the acquisition date. This is because the effects of uncertainty about future cash flows are included in the fair value measure.[204]

Consequently, the accounting for impairment of debt instruments measured at amortised cost or fair value through other comprehensive income under IFRS 9 does not affect the accounting for the business combination. At the acquisition date, the acquired debt instruments are measured at their acquisition-date fair value, in accordance with IFRS 3. No loss allowance is recognised as part of the initial measurement of debt instruments that are acquired in a business combination.

Subsequent accounting for debt instruments acquired in a business combination after their initial recognition is in the scope of IFRS 9. The impairment requirements in IFRS 9 are part of the subsequent measurement of those debt instruments.[205] At the first reporting date after the business combination, following the guidance in IFRS 9, a loss allowance is recognised.[206] This will result in an impairment loss that is recognised in profit or loss (rather than an adjustment to goodwill), just as would be the case if the entity were to originate those assets or acquire them as a portfolio, rather than acquire them through a business combination.[207]

Despite the colloquial reference to a 'day one' loss that results from the ECL impairment model in IFRS 9, it is important to understand that the recognition of a loss allowance for newly acquired (whether purchased or originated) debt instruments that are in the scope of the impairment requirements of IFRS 9 is a matter of subsequent measurement of those financial instruments. This means that the acquirer recognises the loss allowance for all debt instruments acquired in a business combination (that are subject to impairment accounting) in the reporting period that includes the business combination but not as part of that business combination, and with a corresponding impairment loss in profit or loss.

The only exception to this is the specific accounting for purchased or originated credit-impaired financial assets which applies to the extent that the portfolio includes financial assets which are credit-impaired at the acquisition date (i.e., the EIR is determined using a cash flow estimate that includes all ECLs and no allowance is made for ECLs). A financial asset is credit-impaired when one

In addition to recording the acquired assets and liabilities at fair value, the acquirer in a business combination will need to record an expense for 12m ECLs.

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[203] IFRS 3.18, IFRS 3.36
[204] IFRS 3.B41
[205] IFRS 9.5.5, 9.5.2.1, 9.5.2.2
[206] *IFRS 9.5.5.3, 9.5.5.5*
[207] IFRS 9.5.5.8

or more events that have a detrimental impact on the estimated future cash flows of that financial asset have occurred (see section 3.1 above).

6.5 Interaction between expected credit losses calculations and fair value hedge accounting

Previously, the implementation guidance of IAS 39 made it clear that a fair value hedge adjustment would be included in the carrying amount of a financial asset that is subject to the impairment requirements. Otherwise, a part of its carrying amount would not have a loss allowance or the loss allowance would be overstated (in the case of a negative fair value hedge adjustment). This guidance stated that the effect of fair value hedge accounting is to adjust the EIR, which affects the rate used to discount expected future cash flows.[208] The rationale given in the example is that the original interest rate before the hedge becomes irrelevant once the carrying amount of the loan is adjusted for any changes in its fair value attributable to interest rate movements.

Similarly, for a financial asset that becomes credit-impaired, IFRS 9 requires impairment to be measured by reference to the gross carrying amount of the asset, which would include the fair value hedge adjustment. Therefore, for a credit-impaired financial asset in stage 3, the EIR would be adjusted to reflect any fair value hedge adjustment.[209]

However, whereas under IAS 39, most assets that are impaired would not generally be those for which fair value hedge accounting has been undertaken, under the new ECL impairment model an allowance is required for assets in stages 1 and 2, in addition to assets in stage 3. Hence, if the discount rate were to be adjusted whenever fair value hedge is applied, then all fair value hedge adjustments would need to be taken into account in calculating ECLs. This would give rise to significant operational challenges.

IFRS 9 is not explicit on this matter, but two points in the standard would seem to be relevant. First, unlike IAS 39, except for credit-impaired assets, the ECL requirements are not based on an asset's 'carrying amount', but on the contractual cash flows that are expected to be lost. Second, implementation guidance E4.4 in IAS 39, which stated that a fair value hedge adjusts the EIR, was not carried forward into the new standard. We understand that removing this guidance was not intended to change the accounting treatment in this respect. However, another requirement of IAS 39, carried forward into IFRS 9, is that a fair value hedge adjustment is only required to be amortised when the hedged item ceases to be adjusted for changes in fair value attributable to the risk being hedged, which can be read to imply that until then there is no need to adjust the EIR, and hence, the rate used to discount ECLs.[210]

How we see it

We believe the requirement is not clear, so at least until it is clarified, there is an accounting policy choice on the matter. One approach would be to adjust the EIR whenever a fair value hedge adjustment is made and, hence, change the interest rate used to discount expected losses. The other would not take into account the fair value hedge adjustment until the EIR is adjusted to amortise the fair value hedge adjustment.[211] Such an adjustment to the EIR is permitted to commence at any time, but would, at the latest, be required when hedge accounting ceases or when the financial asset becomes credit impaired, i.e., moved to stage 3.

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[208] IAS 39.E.4.4
[209] *IFRS 9.B5.5.33*
[210] IFRS 9.6.5.10
[211] IFRS 9.6.5.8

7 Modified financial assets

If the contractual cash flows on a financial asset are renegotiated or modified, the holder needs to assess whether the financial asset should be derecognised. In summary, an entity should derecognise a financial asset if the cash flows are extinguished or if the terms of the instrument have substantially changed.

7.1 Accounting treatment if modified financial assets are derecognised

In some circumstances, the renegotiation or modification of the contractual cash flows of a financial asset can lead to the derecognition of the existing financial asset and subsequently, the recognition of a new financial asset.[212] This means that the entity is starting afresh and the date of the modification will also be the date of initial recognition of the new financial asset at its fair value. Typically, the entity will recognise a loss allowance based on 12-month ECLs at each reporting date unless the requirements for the recognition of lifetime ECLs are met. However, in what the standard describes as 'some unusual circumstances' following a modification that results in derecognition of the original financial asset, there may be evidence that the new financial asset is credit-impaired on initial recognition (see section 3.3 above). Thus, the financial asset should be recognised as an originated credit-impaired financial asset. In practice, we believe that more restructured financial assets will be treated as originated credit-impaired than the Board seems to have envisaged.[213]

7.2 Accounting treatment if modified financial assets are not derecognised

In other circumstances, the renegotiation or modification of the contractual cash flows of a financial asset does not lead to the derecognition of the existing financial asset as per IFRS 9. In such situations, the entity will:

▸ Continue with its current accounting treatment for the existing asset that has been modified

▸ Recognise a modification gain or loss in profit or loss by recalculating the gross carrying amount of the financial asset as the present value of the renegotiated or modified contractual cash flows, discounted at the financial asset's original EIR (or the credit-adjusted EIR for purchased or originated credit-impaired financial assets). Any costs or fees incurred adjust the carrying amount of the modified financial asset and are amortised over the remaining term of the modified financial asset (see section 3.1 above)[214]

▸ Assess whether there has been a significant increase in the credit risk of the financial instrument, by comparing the risk of a default occurring at the reporting date (based on the modified contractual terms) and the risk of a default occurring at initial recognition (based on the original, unmodified contractual terms). A financial asset that has been renegotiated or modified is not automatically considered to have lower credit risk. The assessment should consider the credit risk over the expected life of the asset based on historical and forward-looking information, including information about the circumstances that led to the modification. Evidence that the criteria for the recognition of lifetime ECLs are subsequently no longer met may include a history of up-to-date and timely payment in subsequent periods.

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[212] IFRS 9.B5.5.25
[213] IFRS 9.B5.5.26
[214] IFRS 9.5.4.3, Appendix A, IAS 1.82(a)

This means a minimum period of observation will often be necessary before a financial asset may qualify to return to stage 1[215]

▸ Make the appropriate quantitative and qualitative disclosures required for renegotiated or modified assets to enable users of financial statements to understand the nature and effect of such modifications (including the effect on the measurement of ECLs) and how the entity monitors its assets that have been modified (see 14 below)[216]

As highlighted above, IFRS 9 introduces explicit guidance on measuring financial assets that have been modified but not derecognised. Under IAS 39, there is no clear guidance on the treatment of modification gains or losses in profit or loss. For entities that have recognised the modification gain or loss over the remaining life of the financial asset by adjusting the EIR prospectively rather than an adjustment to the carrying amount, there will be a need on transition to IFRS 9 to re-assess as at the time of modification, the change in carrying value of the financial asset using the original EIR. The difference in the carrying amounts after taking into account the subsequent amortisation will be recorded in retained earnings on transition.

Reductions in the carrying value will be partially offset by an increase in amortisation in the period between the date of modification and the date of transition, as the original EIR will be used to amortise the modified assets during this period.

The example below has been adapted from Example 11 of the Implementation Guidance in IFRS 9 to illustrate the accounting treatment of a loan that is modified.[217]

Example 18: Modification of contractual cash flow

Bank A originates a five-year loan that requires the repayment of the outstanding contractual amount in full at maturity. Its contractual par amount is €1,000 with an interest rate of 5 per cent, payable annually. The EIR is 5 per cent. At the end of the first reporting period in Year 1, Bank A recognises a loss allowance at an amount equal to 12-month ECLs because there has not been a significant increase in credit risk since initial recognition. A loss allowance balance of €20 is recognised. In Year 2, Bank A determines that the credit risk on the loan has increased significantly since initial recognition. As a result, Bank A recognises lifetime ECLs on the loan. The loss allowance balance is €150.

At the end of Year 3, following significant financial difficulty of the borrower, Bank A modifies the contractual cash flows on the loan. It forgoes interest payments and extends the contractual term of the loan by one year so that the remaining term at the date of the modification is three years. The modification does not result in derecognition of the loan by Bank A.

As a result of that modification, Bank A recalculates the gross carrying amount of the financial asset as the present value of the modified contractual cash flows discounted at the loan's original EIR of 5 per cent. The difference between this recalculated gross carrying amount and the gross carrying amount before the modification is recognised as a modification gain or loss. Bank A recognises the modification loss (calculated as €136) against the gross carrying amount of the loan, reducing it to €864, and a modification loss of €136 in profit or loss.

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[215] IFRS 9.5.5.12, B5.5.27
[216] IFRS 7.35F(f), B8B, 35J
[217] IFRS 9 IG Example 11 IE66-IE73

Bank A also remeasures the loss allowance, taking into account the modified contractual cash flows and evaluates whether the loss allowance for the loan should continue to be measured at an amount equal to lifetime ECLs. Bank A compares the current credit risk (taking into consideration the modified cash flows) to the credit risk (on the original unmodified cash flows) at initial recognition. Bank A determines that the loan is not credit-impaired at the reporting date, but that credit risk has still significantly increased compared with the credit risk at initial recognition. It continues to measure the loss allowance at an amount equal to lifetime ECLs, which are €110 at the reporting date.

At each subsequent reporting date, Bank A continues to evaluate whether there has been a significant increase in credit risk by comparing the loan's credit risk at initial recognition (based on the original, unmodified cash flows) with the credit risk at the reporting date (based on the modified cash flows).

Two reporting periods after the loan modification (Year 5), the borrower has outperformed its business plan significantly compared to the expectations at the modification date. In addition, the outlook for the business is more positive than previously envisaged. An assessment of all reasonable and supportable information that is available without undue cost or effort indicates that the overall credit risk on the loan has decreased and that the risk of a default occurring over the expected life of the loan has decreased, so Bank A adjusts the borrower's internal credit rating at the end of the reporting period.

Given the positive overall development, Bank A re-assesses the situation and concludes that the credit risk of the loan has decreased and there is no longer a significant increase in credit risk since initial recognition. As a result, Bank A once again measures the loss allowance at an amount equal to 12-month ECLs.

Year	Beginning gross carrying amount	Impairment (loss)/gain	Modification (loss)/gain	Interest revenue	Cash flows	Ending gross carrying amount	Loss allowance	Ending amortised cost amount
	A	B	C	D Gross: A × 5%	E	F = A + C + D - E	G	H = F - G
1	€1,000	(€20)		€50	€50	€1,000	€20	€980
2	€1,000	(€130)		€50	€50	€1,000	€150	€850
3	€1,000	€40	(€136)	€50	€50	€864	€110	€754
4	€864	€24		€43		€907	€86	€821
5	€907	€72		€45		€952	€14	€938
6	€952	€14		€48	€1,000	€0	€0	€0

At its meeting on 22 April 2015, the ITG (see section 1.5 above) discussed the measurement of ECLs in respect of a modified financial asset where the modification does not result in derecognition, but the cash flows have been renegotiated to be consistent with those previously expected to be paid.[218]

The ITG noted that IFRS 9 is clear that an entity is required to calculate a new gross carrying amount and the gain or loss on modification taken to profit or loss should be based on the renegotiated or modified contractual cash flows and excludes ECLs unless it is a purchased or originated credit-impaired financial asset.[219] Consequently, an entity must calculate the gain or loss on modification as a first step before going on to consider the revised ECL

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[218] Transition Resource Group for Impairment of Financial Instruments, Agenda ref 8, *Measurement of expected credit losses in respect of a modified financial asset*, 22 April 2015.

[219] IFRS 9.5.4.3, Appendix A

allowance required on the modified financial asset. Thereafter, the entity is required to continue to apply the impairment requirements to the modified financial asset in the same way as it would for other unmodified financial instruments, taking into account the revised contractual terms.[220] The revised ECL cannot be assumed to be nil as, in accordance with paragraph 5.5.18 of IFRS 9, an entity is required to consider the possibility that a credit loss occurs, even if the likelihood of that credit loss occurring is very low.[221]

The ITG also discussed the appropriate presentation and disclosure requirements pertaining to modifications. These are discussed further in section 14.

We note that if an entity has no reasonable expectations of recovering a portion of the financial asset, which is subsequently forgiven, then this amount should arguably be written off, as a partial derecognition. The gross carrying amount would be reduced directly before a modification gain or loss is calculated.[222] This will mean that the loss will be recorded as an impairment loss, rather than as a loss on modification, and presented differently in the profit or loss account.

8 Financial assets measured at fair value through other comprehensive income

For financial assets measured at fair value through other comprehensive income, the ECLs do not reduce the carrying amount in the statement of financial position, which remains at fair value. Instead, an amount equal to the allowance that would arise if the asset were measured at amortised cost is recognised in other comprehensive income as the 'accumulated impairment amount'.[223]

8.1 Accounting treatment for debt instruments measured at fair value through other comprehensive income

The accounting treatment and journal entries for debt instruments measured at fair value through other comprehensive income are illustrated in the following example, based on Illustrative Example 13 in the Implementation Guidance for the standard.[224]

> For debt instruments measured at FVOCI, ECLs do not reduce the carrying amount in the statement of financial position, which remains at fair value. Instead, an amount equal to the allowance that would arise if the asset was measured at amortised cost, is recognised in other comprehensive income .

Example 19: Debt instrument measured at fair value through other comprehensive income

An entity purchases a debt instrument with a fair value of £1,000 on 15 December 2018 and measures the debt instrument at fair value through other comprehensive income (FVOCI). The instrument has an interest rate of 5 per cent over the contractual term of 10 years, and has a 5 per cent EIR. At initial recognition the entity determines that the asset is not purchased or originated credit-impaired.

	Debit	Credit
Financial asset – FVOCI	£1,000	
Cash		£1,000
(To recognise the debt instrument measured at its fair value)		

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[220] IFRS 9.5.5.12
[221] IFRS 9.5.5.18
[222] *IFRS 9.5.4.4, B5.4.9*
[223] IFRS 9.4.1.2A, 5.5.2, Appendix A
[224] IFRS 9 IG Example 13, IE78-IE81

On 31 December 2018 (the reporting date), the fair value of the debt instrument has decreased to £950 as a result of changes in market interest rates. The entity determines that there has not been a significant increase in credit risk since initial recognition and that ECLs should be measured at an amount equal to 12-month ECLs, which amounts to £30. For simplicity, journal entries for the receipt of interest revenue are not provided.

	Debit	Credit
Impairment loss (profit or loss)	£30	
Other comprehensive income[(a)]	£20	
Financial asset – FVOCI		£50

(To recognise 12-month ECLs and other fair value changes on the debt instrument)

(a) *The* cumulative loss in other comprehensive income at the reporting date was £20. That amount consists of the total fair value change of £50 (i.e., £1,000 – £950) offset by the change in the accumulated impairment amount representing 12-month ECLs that was recognised (£30).

Disclosure would be provided about the accumulated impairment amount of £30. On 1 January 2019, the entity decides to sell the debt instrument for £950, which is its fair value at that date.

	Debit	Credit
Cash	£950	
Financial asset – FVOCI		£950
Loss (profit or loss)	£20	
Other comprehensive income		£20

(To derecognise the fair value through other comprehensive income asset and recycle amounts accumulated in other comprehensive income to profit or loss, i.e. £20).

This means that, in contrast to financial assets measured at amortised cost, there is no separate allowance. Instead, impairment gains or losses are accounted for as an adjustment of the revaluation reserve accumulated in other comprehensive income, with a corresponding charge to profit or loss (which is then reflected in retained earnings).

As explained in section 6.3.1 above, IFRS 9 requires a derecognition gain or loss to be measured relative to the carrying amount at the date of derecognition. This necessitates an assessment and measurement of ECLs for that particular asset as at the date of derecognition.

8.2 Interaction between foreign currency translation, fair value hedge accounting and impairment

The above example is relatively straightforward. A more complicated one, based on a foreign currency denominated financial asset which is also the subject of an interest rate hedge, is provided below. It is based on Illustrative Example 14 in the Implementation Guidance for the standard, but has been adjusted so as to include the effect of discounting in the measurement of ECLs (see section 4.7 above).[225] Note that we do not address the additional complexities that will arise from the consideration of taxation, including deferred tax.

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[225] IFRS 9.IE82-IE102

Example 20: Interaction between the fair value through other comprehensive income measurement category and foreign currency denomination, fair value hedge accounting and impairment

The example assumes the following fact pattern and that, on initial recognition, ECLs are included when measuring foreign exchange gains and losses (see section 6.3.1 above):

- An entity purchases a bond denominated in a foreign currency (FC) for its fair value of FC100,000 on 1 January 2018.

- The bond is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets and has contractual cash flows which are solely payments of principal and interest on the principal amount outstanding. Therefore, the entity classifies the bond as measured at fair value through other comprehensive income.

- The bond has five years remaining to maturity and a fixed coupon of 5 per cent over its contractual life on the contractual par amount of FC100,000.

- The entity hedges the bond for its interest rate related fair value risk. The fair value of the corresponding interest rate swap at the date of initial recognition is nil.

- On initial recognition, the bond has a 5 per cent EIR which results in a gross carrying amount that equals the fair value at initial recognition.

- The entity's functional currency is its local currency (LC).

- As at 1 January 2018, the exchange rate is FC1 to LC1.

- At initial recognition, the entity determines that the bond is not purchased credit-impaired. The entity applies a 12-month PD for its impairment calculation and assumes that payment default occurs at the end of the reporting period (i.e., after 12 months). In particular, the entity estimates the PD over the next 12 months at 2 per cent and the LGD at FC60,000, resulting in an (undiscounted) expected cash shortfall of FC1,200. The discounted expected cash shortfall is FC1,143 at 5 per cent EIR (see the example below for the detailed calculation).

- For simplicity, amounts for interest revenue are not provided. It is assumed that interest accrued is received in the period. Differences of 1 in the calculations and reconciliations are due to rounding.

The entity hedges its risk exposures using the following risk management strategy:

(a) for fixed interest rate risk (in FC) the entity decides to link its interest receipts in FC to current variable interest rates in FC. Consequently, the entity uses interest rate swaps denominated in FC under which it pays fixed interest and receives variable interest in FC; and

(b) for foreign exchange (FX) risk, the entity decides not to hedge against any variability in LC arising from changes in foreign exchange rates.

The entity designates the following hedging relationship: a fair value hedge of the bond in FC as the hedged item with changes in benchmark interest rate risk in FC as the hedged risk. The entity enters into a swap that pays fixed and receives variable interest in FC on the same day and designates the swap as the hedging instrument. The tenor of the swap matches that of the hedged item (i.e., five years). This example assumes that all qualifying criteria for hedge accounting are met (see paragraph 6.4.1 of IFRS 9). The description of the designation is solely for the purpose of understanding this example (i.e., it is not an example of the complete formal documentation required in accordance with paragraph 6.4.1 of IFRS 9).

This example assumes that no hedge ineffectiveness arises in the hedging relationship. This assumption is made in order to better focus on illustrating the accounting mechanics in a situation that entails measurement at fair value through other comprehensive income of a foreign currency financial instrument that is designated in a fair value hedge relationship, and also to focus on the recognition of impairment gains or losses on such an instrument.

The entity decided not to amortise the fair value hedge adjustment to profit or loss before the hedge ceases or the asset is credit-impaired. Consequently, in this example, there is no adjustment to the EIR due to fair value hedge accounting. However, such an adjustment to the EIR would at the latest be required when the entity ceases to apply hedge accounting or when the asset becomes credit-impaired, i.e., moved to stage 3 (See section 6.5 above).

Situation as per 1 January 2018

The table below illustrates the amounts recognised in the financial statements as per 1 January 2018, as well as the shadow amortised cost calculation for the bond, based on the fact pattern described above (debits are shown as positive numbers and credits as negative numbers):

	Financial Statements			Shadow Calculation	
	FC	LC		FC	LC
Statement of financial position					
Bond (FV)	100,000	100,000	Gross carrying amount	100,000	100,000
Swap (FV)	-	-	Loss allowance	(1,143)	(1,143)
			Amortised cost	98,857	98,857
Statement of profit or loss					
Impairment	1,143	1,143	FV hedge adjustment	-	-
FV hedge (bond)	-	-	Adjusted gross carrying amt.	100,000	100,000
FX gain/loss (bond)	-	-	Adjusted amortised cost	98,857	98,857
FV hedge (swap)	-	-			
FX gain/loss (swap)	-	-			
Statement of OCI					
FV changes	-	-			
Impairment offset	(1,143)	(1,143)			
FV hedge adjustment	-	-			

Example 20: Interaction between the fair value through other comprehensive income measurement category and foreign currency denomination, fair value hedge accounting and impairment (cont'd)

As per 1 January 2018, the entity recognises the bond and the swap at their initial fair values of LC100,000 and nil, respectively. The loss allowance of FC1,143 is recognised in profit or loss. The amount is calculated as the difference between all contractual cash flows that are due to the entity in accordance with the contract and all the cash flows that the entity expects to receive (i.e., all cash shortfalls), discounted at the original effective interest of 5 per cent, and weighted by the probability of the scenario occurring. To keep the example simple, it is assumed that default on the bond occurs one year after the date of the initial recognition, at which point the recoverable amount of the bond is received. This means that in the case of a default the entity expects cash flows of FC45,000 (which is the principal of FC100,000 plus one year of interest of FC5,000 less the LGD of FC60,000). The latter loss is discounted by the 5 per cent EIR and weighted by the 2 per cent PD to arrive at the loss allowance. The table below shows the ECL calculation:

1 January 2018 (values in FC)		Year 1	Year 2	Year 3	Year 4	Year 5
Contractual cash flows		5,000	5,000	5,000	5,000	**105,000**
Expected cash flows		45,000				
Expected cash shortfalls		40,000	(5,000)	(5,000)	(5,000)	**(105,000)**
NPV at 5%	(57,143)					
PD	2%					
ECL	(1,143)					

In accordance with paragraph 16A of IFRS 7, the loss allowance for financial assets measured at fair value through other comprehensive income is not presented separately as a reduction of the carrying amount of the financial asset. As a consequence, the offsetting entry to the impairment loss of LC1,143 is recorded in other comprehensive income in the same period.

Situation as at 31 December 2018

As of 31 December 2018 (the reporting date), the entity observes the following facts:

▸ The fair value of the bond has decreased from FC100,000 to FC96,370, mainly because of an increase in market interest rates.

▸ The fair value of the swap has increased to FC1,837.

▸ In addition, as at 31 December 2018, the entity determines that there has been no change to the credit risk on the bond since initial recognition. The entity still estimates the PD over the next 12 months at 2 per cent and the LGD at FC60,000, resulting in an (undiscounted) expected shortfall of FC1,200.

▸ As at 31 December 2018, the exchange rate is FC1 to LC1.4.

The table below illustrates the amounts recognised in the financial statements between 1 January 2018 (after the entries for the impairment loss of FC1,143 at 1 January, shown above) and 31 December 2018, as well as the shadow amortised cost calculation for the bond (debits are shown as positive numbers and credits as negative numbers)

| | Financial statements | | | Shadow calculation | |
	FC	LC		FC	LC
	Statement of financial position				
Bond (FV)	96,370	134,918	Gross carrying amount	100,000	140,000
Swap (FV)	1,837	2,572	Loss allowance	(1,143)	(1,600)
			Amortised cost	98,857	138,400
	Statement of profit or loss				
Impairment	–	–	FV hedge adjustment	(1,837)	(2,572)
FV hedge (bond)	1,837	2,572	Adjusted gross carrying amount	98,163	137,428
FX gain/loss (bond)		(39,543)	Adjusted amortised cost	97,020	135,828
FV hedge (swap)	(1,837)	(2,572)			
FX gain/loss (swap)	–	–			
	Statement of OCI				
FV changes	3,630	4,625			
Impairment offset	–	–			
FV hedge adjustment	(1,837)	(2,572)			

Because the entity has maintained the expected cash shortfall pattern and its probability of occurring, the change in estimate is just the effect of deferral by a year of the expected date of default, which exactly offsets the unwinding of the discount.

The bond is a monetary asset. Consequently, the entity recognises the changes arising from movements in foreign exchange rates in profit or loss in accordance with paragraphs 23(a) and 28 of IAS 21 and recognises other changes in accordance with IFRS 9. For the purposes of applying paragraph 28 of IAS 21, the asset is treated as an asset measured at amortised cost in the foreign currency.

The change in the fair value of the bond since 1 January 2018 amounts to LC34,918 and is recognised as a fair value adjustment to the carrying amount of the bond on the entity's statement of financial position.

The gain of LC39,543 due to the changes in foreign exchange rates is recognised in profit or loss. It consists of the impact of the change in the exchange rates during 2018:

‣ On the original gross carrying amount of the bond, amounting to LC40,000
‣ Offset by the loss allowance of the bond, amounting to LC457 (i.e., the difference of FC1,143 translated at the exchange rate as at 1 January 2018 of FC1 to LC1 and FC1,143 translated at the exchange rate as at 31 December 2018 of FC1 to LC1.4)

The difference between the change in fair value (LC34,918) and the gain recognised in profit or loss that is due to the changes in foreign exchange rates (LC39,543) is recognised in OCI. That difference amounts to LC4,625.

A gain of LC2,572 (FC1,837) on the swap is recognised in profit or loss and, because it is assumed that there is no hedge ineffectiveness, this amount coincides with the loss on the hedged item. Illustrative Example 14 of IFRS 9 seems to suggest that the hedging gain or loss of a debt instrument at fair value through other comprehensive income is recycled from other comprehensive income in the same period but, since paragraph 6.5.8(b) of IFRS 9 requires the hedging gain or loss on the hedged item to be recognised in profit or loss and the offsetting entry is to OCI, this is not strictly 'recycling'

Situation as at 31 December 2019

As of 31 December 2019 (the reporting date), the entity observes the following facts:

▸ The fair value of the bond has further decreased from FC96,370 to FC87,114.

▸ The fair value of the swap has increased to FC2,092.

▸ Based on adverse macroeconomic developments in the industry in which the bond issuer operates, the entity assumes a significant increase in credit risk since initial recognition, and recognises the lifetime ECL for the bond.

▸ The entity updates its impairment estimate and now estimates the lifetime PD at 20 per cent and the LGD at FC48,500, resulting in (undiscounted) expected cash shortfalls of FC9,700. (For simplicity, this example assumes that payment default will happen on maturity when the entire face value becomes due).

▸ As at 31 December 2019, the exchange rate is FC1 to LC1.25.

The table below illustrates the amounts recognised in the financial statements between 31 December 2018 and 31 December 2019, as well as the shadow amortised cost calculation for the bond (debits are shown as positive numbers and credits as negative numbers):

| | Financial statements | | | Shadow calculation | |
	FC	LC		FC	LC
Statement of financial position					
Bond (FV)	87,114	108,893	Gross carrying amount	100,000	125,000
Swap (FV)	2,092	2,615	Loss allowance	(8,379)	(10,474)
			Amortised cost	91,621	114,526
Statement of profit or loss					
Impairment	7,236	9,045	FV hedge adjustment	(2,092)	(2,615)
FV hedge (bond)	255	319	Adj. gross carrying amt.	97,908	122,385
FX gain/loss (bond)		14,553	Adj. amortised cost	89,529	111,911
FV hedge (swap)	(255)	(319)			
FX gain/loss (swap)		276			
Statement of OCI					
FV changes	9,256	11,472			
Impairment offset	(7,236)	(9,045)			
FV hedge adjustment	(255)	(319)			

The table below illustrates the ECL calculation:

31 December 2019 (values in FC)		Year 3	Year 4	Year 5
Contractual cash flows		5,000	5,000	105,000
Expected cash flows		5,000	5,000	56,500
Expected cash shortfalls		-	-	(48,500)
NPV at 5%	(41,896)			
PD	20%			
ECL	(8,379)			

Again, the table above shows how the ECL is calculated as the net present value of the cash shortfalls, i.e., the difference between contractual and expected cash flows on each relevant date multiplied by the PD. The offsetting entry of the impairment loss FC7,236 (LC9,045) is recorded in other comprehensive income in the same period.

The change in the fair value of the bond since 31 December 2018 amounts to a decrease of LC26,026 and is recognised as a fair value adjustment to the carrying amount of the bond on the entity's statement of financial position.

The loss of LC14,553 due to the changes in foreign exchange rates is recognised in profit or loss. It consists of the impact of the change in the exchange rates during 2019:

▸ On the original gross carrying amount of the bond, amounting to a loss of LC15,000;

▸ On the loss allowance of the bond, amounting to a gain of LC171;

▸ On the fair value hedge adjustment, amounting to a gain of LC276.

The difference between the change in fair value (decrease of LC26,026) and the loss recognised in profit or loss that is due to the changes in foreign exchange rates (-LC14,553) is recognised in OCI.

A gain of LC319 (FC255) on the swap is recognised in profit or loss and, because it is assumed that there is no hedge ineffectiveness, this amount coincides with the loss on the hedged item.

Situation as at 1 January 2020

On 1 January 2020, the entity decides to sell the bond for FC87,114, which is its fair value at that date and also closes out the swap at its fair value. For simplicity, all amounts, including the foreign exchange rate, are assumed to be the same as at 31 December 2019.

Upon derecognition, the entity reclassifies the cumulative amount recognised in OCI of (LC3,018) ((FC2,415)) to profit or loss. This amount is equal to the difference between the fair value and the adjusted amortised cost amount of the bond, including the fair value hedge adjustment at the time of its derecognition. The table below presents a reconciliation of those amounts.

Example 20: Interaction between the fair value through other comprehensive income measurement category and foreign currency denomination, fair value hedge accounting and impairment (cont'd)

Reconciliation of loss on derecognition (values in LC) to cumulative OCI	
Fair value per 1 January 2020	108,893
Adjusted amortised cost per 1 January 2020	111,911
Loss	**(3,018)**

	Cum. OCI	1 January 2018	31 December 2018	31 December 2019
FV changes	**16,097**	–	4,625	11,472
Impairment	**(10,188)**	(1,143)	–	(9,045)
FV hedge adjustment	**(2,891)**	–	(2,572)	(319)
Total OCI to be reclassified	**3,018**			

This table presents the amount that has not yet been recycled and, therefore, must be reclassified to profit or loss on derecognition.

9 Trade receivables, contract assets and lease receivables

The standard provides some operational simplifications for trade receivables, contract assets and lease receivables. These are the requirement or policy choice to apply the simplified approach that does not require entities to track changes in credit risk (see section 3.2 above) and the practical expedient to calculate ECLs on tradaawe receivables using a provision matrix (see 9.1 below).

9.1 Trade receivables and contract assets

It is a requirement for entities to apply the simplified approach for trade receivables or contract assets that do not contain a significant financing component. However, entities have a policy choice to apply either the general approach (see section 3.1 above) or the simplified approach separately to trade receivables and contract assets that do contain a significant financing component (see section 3.2 above).[226]

Also, entities are allowed to use practical expedients when measuring ECLs, as long as the approach reflects a probability-weighted outcome, the time value of money and 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.[227]

One of the approaches suggested in the standard is the use of a provision matrix as a practical expedient for measuring ECLs on trade receivables. For instance, the provision rates might be based on days past due (e.g., 1 per cent if not past due, 2 per cent if less than 30 days past due, etc.) for groupings of various customer segments that have similar loss patterns. The grouping may be based on geographical region, product type, customer rating, type of collateral or whether covered by trade credit insurance, and the type of customer (such as wholesale or retail). To calibrate the matrix, the entity would adjust its historical credit loss experience with forward-looking information.[228]

In practice, many corporates use a provision matrix to calculate their current impairment allowances. However, in order to comply with the IFRS 9 requirements, corporates would need to consider how current and forward-looking information might affect their customers' historical default rates and, consequently, how the information would affect their current expectations and estimates of ECLs. The use of the provision matrix is illustrated in the following example:[229]

Example 21: Provision matrix

Company M, a manufacturer, has a portfolio of trade receivables of €30 million in 2018 and operates only in one geographical region. The customer base consists of a large number of small clients and the trade receivables are categorised by common risk characteristics that are representative of the customers' abilities to pay all amounts due in accordance with the contractual terms. The trade receivables do not have a significant financing component in accordance with IFRS 15. In accordance with paragraph 5.5.15 of IFRS 9, the loss allowance for such trade receivables is always measured at an amount equal to lifetime ECLs.

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[226] IFRS 9.5.5.15(a)
[227] IFRS 9.5.5.17, B5.5.35
[228] IFRS 9.B5.5.35
[229] IFRS 9 IG Example 12, IE74-IE77

> ### Example 21: Provision matrix (cont'd)
>
> To determine the ECLs for the portfolio, Company M uses a provision matrix. The provision matrix is based on its historical observed loss rates over the expected life of the trade receivables and is adjusted for forward-looking estimates. At every reporting date, the historical observed loss rates are updated and changes in the forward-looking estimates are analysed. In this case, it is forecast that economic conditions will deteriorate over the next year.
>
> On that basis, Company M estimates the following provision matrix:
>
> | | Current | 1-30 days past due | 31-60 days past due | 61-90 days past due | More than 90 days past due |
> |---|---|---|---|---|---|
> | Loss rate | 0.3% | 1.6% | 3.6% | 6.6% | 10.6% |
>
> The trade receivables from the large number of small customers amount to €30 million and are measured using the provision matrix.
>
> | | Gross carrying amount | Lifetime ECL allowance (Gross carrying amount × lifetime ECL rate) |
> |---|---|---|
> | Current | €15,000,000 | €45,000 |
> | 1-30 days past due | €7,500,000 | €120,000 |
> | 31-60 days past due | €4,000,000 | €144,000 |
> | 61-90 days past due | €2,500,000 | €165,000 |
> | More than 90 days past due | €1,000,000 | €106,000 |
> | | €30,000,000 | €580,000 |
>
> It should be noted that this example, like many in the standard, ignores the need to consider explicitly the time value of money, presumably in this case because the effect is considered immaterial.

9.2 Lease receivables

For lease receivables, entities have a policy choice to apply either the general approach (see section 3.1 above) or the simplified approach (see section 3.2 above) separately to finance and operating lease receivables.[230]

> **For lease receivables, entities have a policy choice to apply either the general approach or the simplified approach.**

When measuring ECLs for lease receivables, an entity should:

▸ Use the cash flows that are used in measuring the lease receivables in accordance with IAS 17 or IFRS 16 (when applied)[231]

▸ Discount the ECLs using the same discount rate used in the measurement of the lease receivables in accordance with IAS 17 or IFRS 16 (when applied)[232]

There has been some discussion on whether the unguaranteed residual value (URV) of the asset subject to a finance lease should be included in the calculation of ECLs under IFRS 9. The URV is part of the gross investment in the finance lease, together with the minimum lease payments receivable by the lessor. Changes to URV arise from fluctuations in the price that could be received for the leased asset at the end of the lease term. Paragraph 2.1(b) of IFRS 9 scopes out rights and obligations under leases to which IAS 17 applies, except for the impairment of finance lease receivables (i.e., net investments

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[230] IFRS 9.5.5.15(b)
[231] IFRS 9.B5.5.34
[232] IFRS 9.B5.5.46, IAS 17.4

in finance leases) and operating lease receivables recognised by a lessor (see section 2 above). Furthermore, IAS 17 does not provide guidance on impairment of lease receivables as this is subject to IFRS 9. However, IAS 17 and IFRS 16 (when applied) provide guidance on measurement of the URV, which means that such measurement is within the scope of IAS 17 or IFRS16 (when applied) rather than the impairment requirements of IFRS 9.[233]

> ## How we see it
>
> The URV of the asset underlying a finance lease should be excluded from the calculation of ECLs under IFRS 9. This means that the collateral that is taken into account in measuring ECLs should exclude any amounts attributed to URV and recorded on the lessor's statement of financial position.

10 Loan commitments and written financial guarantee contracts

The description of 'loan commitment' and the definition of 'financial guarantee contract' remain unchanged from IAS 39. Loan commitments are described in IFRS 9 as 'firm commitments to provide credit under pre-specified terms and conditions', while a financial guarantee contract is defined as 'a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument'.[234]

The IFRS 9 impairment requirements apply to loan commitments and financial guarantee contracts that are not measured at fair value through profit or loss under IFRS 9, with some exceptions (see section 2 above).

The ITG (seesection 1.5 above) discussed in April 2015 whether the impairment requirements in IFRS 9 must also be applied to other commitments to extend credit such as:

▸ A commitment (on inception of a finance lease) to commence a finance lease at a date in the future (i.e., a commitment to transfer the right to use an asset at the lease commencement date in return for a payment or series of payments in the future)

▸ A commitment by a retailer through the issue of a store account to provide a customer with credit when the customer buys goods or services from the retailer in the future

The ITG appeared to agree with the IASB's staff analysis that the impairment requirements of IFRS 9 apply to an agreement that contains a commitment to extend credit by virtue of paragraph 2.1(g) if:

▸ The agreement meets the description of a loan commitment[235]

▸ The agreement meets the definition of a financial instrument[236]

    And

▸ None of the specific exemptions from the requirements of IFRS 9 apply[237]

<div style="margin-left:2em; color:#888;">
The IFRS 9 impairment requirements apply to loan commitments and financial guarantee contracts that are not measured at fair value through profit or loss under IFRS 9.
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[233] IAS 17.41, IFRS 16.77
[234] IFRS 9.BCZ2.2, Appendix A, IAS 39.9, BC15
[235] IFRS 9.BCZ2.2
[236] IAS 32.11
[237] *IFRS 9.2.1*

The IASB staff paper stated that some contracts, such as irrevocable finance lease agreements, might clearly contain a firm commitment at inception to provide credit under pre-specified terms and conditions. However, other cases might not be so clear cut, depending upon the specific terms of the agreement and other facts and circumstances (e.g., if the issuer of a store account has the discretion to refuse to sell products or services to a customer with a store card and, hence, can avoid extending credit).[238]

In the examples discussed above, the finance lease and store account do not meet the definition of a financial instrument until the contractual right to receive cash is established, that is likely to be at the commencement of the lease term or when goods or services are sold.[239] Only lease receivables are scoped into the IFRS 9 impairment requirements (see section 9.2 above).[240] Consequently, there is no need to make provision for ECLs, in accordance with IFRS 9, until a financial lease receivable or a financial asset within the scope of IFRS 9 is recognised.

The application of the model to financial guarantees and loan commitments warrants some further specification regarding some of the key elements, such as the determination of the credit quality on initial recognition, cash shortfalls and the EIR to be used in the ECL calculations. These specifications are summarised in the table below, which also highlights the differences in recognising and measuring ECLs for financial assets measured at amortised cost or at fair value through other comprehensive income, loan commitments and financial guarantee contracts.

Figures 6: Summary of the application of the ECL model to loan commitments and financial guarantee contacts			
	Financial assets measured at amortised cost or at fair value through other comprehensive income	Loan commitments	Financial guarantee contracts
Date of initial recognition in applying the impairment requirements (see sections 6.3.1 above and 6.2.1 below)	Trade date.[241]	Date that an entity becomes a party to the irrevocable commitment.[242]	Date that an entity becomes a party to the irrevocable commitment.[243]

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[238] Transition Resource Group for Impairment of Financial Instruments, Agenda ref 3, *Loan Commitments – Scope*, 22 April 2015.
[239] IAS 32.11, AG20
[240] *IFRS 9.2.1(b)*
[241] IFRS 9.5.7.4
[242] IFRS 9.5.5.6
[243] IFRS 9.5.5.6

Period over which to estimate ECLs (see 4.5 above)	The expected life up to the maximum contractual period (including extension options at the discretion of the borrower) over which the entity is exposed to credit risk and not a longer period.[244]	The expected life up to the maximum contractual period over which an entity has a present contractual obligation to extend credit.[245] However, for revolving credit facilities (see section 11 below), this period extends beyond the contractual period over which the entity is exposed to credit risk and the ECLs would not be mitigated by credit risk management actions.[246]	The expected life up to the maximum contractual period over which an entity has a present contractual obligation to extend credit.[247]
Cash shortfalls in measuring ECLs (see section 4.2 above)	Cash shortfalls between the cash flows that are due to an entity in accordance with the contract and the cash flows that the entity expects to receive.[248]	Cash shortfalls between the contractual cash flows that are due to the entity if the holder of the loan commitment draws down the loan and the cash flows that the entity expects to receive if the loan is drawn down.[249]	Cash shortfalls are the expected payments to reimburse the holder for a credit loss that it incurs less any amounts that the entity (issuer) expects to receive from the holder, the debtor or any other party.[250]
EIR used in discounting ECLs (see section 4.7 above)	The EIR is determined or approximated at initial recognition of the financial instrument.[251]	The EIR of the resulting asset will be applied and if this is not determinable, then the current rate representing the risk of the cash flows is used.[252]	The current rate representing the risk of the cash flows is used.[253]
Assessment of significant increases in credit risk (see section 5 above)	An entity considers changes in the risk of a default occurring on the financial asset.[254]	An entity considers changes in the risk of a default occurring on the loan to which a loan commitment relates.[255]	An entity considers the changes in the risk that the specified debtor will default on the contract.[256]

[244] IFRS 9.5.5.19
[245] IFRS 9.B5.5.38
[246] IFRS 9.5.5.20, B5.5.39, B5.5.40
[247] IFRS 9.B5.5.38
[248] IFRS 9.B5.5.28
[249] IFRS 9.B5.5.30
[250] IFRS 9.B5.5.32
[251] IFRS 9.B5.5.44
[252] IFRS 9.B5.5.47, B5.5.48
[253] IFRS 9.B5.5.48
[254] IFRS 9.5.5.9
[255] IFRS 9.B5.5.8
[256] IFRS 9.B5.5.8

At its meeting in April 2015, the ITG (see section 1.5 above) also discussed the measurement of ECLs for an issued financial guarantee contract that requires the holder to pay further premiums in the future. Some members of the ITG agreed with the staff's analysis that the issuer of a financial guarantee contract should exclude future premium receipts due from the holder when measuring ECLs in respect of the expected cash outflows payable under the guarantee.[257] When estimating the cash shortfalls, the amounts that the entity expects to receive from the holder should relate only to recoveries or reimbursements of claims for losses and would not include receipts of premiums.[258] Moreover, the expected cash outflows under the guarantee depend upon the risk of default of the guaranteed asset, while the expected future premiums receipts are subject to the risk of default by the holder of the guarantee. Hence, these risks of default should be considered separately. This means that the ECL measurement should be carried out gross of any premiums receivable in the future.

In addition, an ITG member noted that the terms of a financial guarantee contract may affect the period of exposure to credit risk on the guarantee, for example, if the guarantee were contingent or cancellable. This should be taken into consideration when measuring the ECLs of the guarantee.

IFRS 9 requires that financial guarantees and off-market loan commitments should be measured at the "higher of" the amount intially recognised less cumulative amortisation, and the ECL.[259] Consequently, the timing of premium payments and, hence, the amount intially required, can result in no ECL provision being recognised required on initial recognition.

For a financial guarantee contract issued to an unrelated party in a stand-alone arm's length transaction, premiums that are received in full at inception will likely be the same as the fair value of the guarantee at initial recognition. In such circumstances, it is likely that no ECLs will need to be recognised immediately after initial recognition, as the initial fair value will normally exceed the lifetime ECLs. However, a financial guarantee contract for which premiums are receivable over the life of the guarantee will have a nil fair value at initial recognition. In such circumstances, the subsequent measurement of the financial guarantee contract is likely to be based on the ECL allowance. This is illustrated in the example below:

> **Example 22: Determining the initial and subsequent measurement of a financial guarantee contract where premiums are receivable upfront or over the life of the guarantee**
>
> *Scenario 1:* On 1 January 2018, Bank A issues a 5 year financial guarantee of a loan with a nominal value of £2,000,000 with 5% interest, with the full premium of £100,000 receivable upfront at contract inception. This premium is recognised on a straight line basis over the life of the guarantee. As at 31 December 2020 and 2021, Bank A assesses that there has been a significant increase in credit risk of the financial guarantee contract and, as at 31 December 2022, the debtor defaults and fails to make payments in accordance with the terms of the debt instrument. The lifetime ECLs estimated as at 31 December 2018 and 2019 are £75,000 and £55,000, respectively, with a significant increase in 2020 and 2021 to £200,000 and £500,000, respectively, and for the guaranteed amount of £2,100,000, including accrued interest in 2022 when the debtor defaults. The 12-month ECLs are £18,000 and £25,000 as at 31 December 2018 and 2019.

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[257] Transition Resource Group for Impairment of Financial Instruments, Agenda ref 6, *Measurement of expected credit losses for an issued financial guarantee contract,* 22 April 2015.
[258] IFRS 9.B5.5.32
[259] IFRS 9.4.2.1(c), 4.2.1(d)

Scenario 2: Same facts as in Scenario 1, except that Bank B issues a 5 year financial guarantee of a loan with a nominal value of £2,00,000, with premiums receivable over the life of the guarantee of £20,000 each year, payable on 31 December 2018, 2019, 2020, 2021 and 2022, i.e., a total of £100,000. The fair value of the guarantee is nil at origination. If a claim is paid out under the financial guarantee contract, Bank B will lose the right to receive future premiums.

	31 Dec 2018	31 Dec 2019	31 Dec 2020	31 Dec 2021	31 Dec 2022
Scenario 1: Full premium receivable at inception Initial fair value is £100,000					
Fair value less cumulative income recognised*	£80,000	£60,000	£40,000	£20,000	-
ECLs	£18,000	£25,000	£200,000	£500,000	£2,100,000
Recorded value: higher of (a) or (b) in accordance with IFRS 9.4.2.1(c)	£80,000	£60,000	£200,000	£500,000	£2,100,000
Scenario 2: Premium receivable over the life of contract Initial fair value is £0 in accordance with IFRS 9.5.1.1	£20,000	£20,000	£20,000	£20,000	£20,000
(a) Fair value less cumulative income recognised*	-	-	-	-	-
(b) ECLs	£18,000	£25,000	£200,000	£500,000	£2,100,000
Recorded value: higher of (a) or (b) in accordance with IFRS 9.4.2.1(c)	£18,000	£25,000	£200,000	£500,000	£2,100,000

* Based on the assumption of a straight-line amortisation of premiums received over the life of the financial guarantee.

Before there has been a significant increase in credit risk in 2018 and 2019, in Scenario 1, the measurement of the financial guarantee is based on the fair value, less cumulative income recognised in accordance with IFRS 15, whilst, in Scenario 2,

> **Example 22: Determining the initial and subsequent measurement of a financial guarantee contract where premiums are receivable upfront or over the life of the guarantee (cont'd)**
>
> the measurement is based on the ECL allowance. However, once there has been a significant increase in credit risk, the measurement of the financial guarantee is based on the ECL allowance in both scenarios. Consequently, the timing of receipt of premiums may have a significant effect on the measurement of the guarantee particularly when there has not been a significant increase in credit risk.
>
> Although the accounting treatment in Scenario 2 in the example above may seem counterintuitive, in that the guarantor must initially recognise ECLs even though it expects to receive future premium income, it is consistent with the impairment of loans for which risk premiums are also received over the life of the loan. Also, in practice, it is relatively unusual for guarantors not to receive premiums upfront when issuing a financial guarantee contract.

Normal loan commitments issued at market interest rates are excluded from the scope of IFRS 9 except for impairment and derecognition.[260] Unlike off-market loan commitments, i.e., loan commitments provided at below-market interest rates, and financial guarantee contracts (see above), normal loan commitments are not subject to the 'higher of' test for subsequent measurement.[261] The consequence is that an ECL is required for all normal loan commitments, whether or not any fees are paid upfront. This is consistent with the general requirement to provide for 12-month ECLs for any new loans that have not experienced significant increases in credit risk since initial recognition.

Another question that arises in practice is whether loan commitments and financial guarantee contracts can ever be accounted for as purchased or originated credit-impaired. The definition of 'purchased or originated credit-impaired' in IFRS 9 refers only to financial assets, not financial instruments (consistent with the definition of credit-impaired) but loan commitments and financial guarantees are not financial assets. So, if such an instrument is entered into when default is highly likely or has already occurred, and the potential loss is reflected in the price, how should the ECLs be measured, so as to avoid double counting the loss? This issue could be particularly relevant in the context of business combinations, where an entity may acquire loan commitments or financial guarantee contracts that are already credit-impaired. For financial guarantees, the 'higher of' test avoids the double-counting, as the fair value of the guarantee recognised as a liability on initial recognition will be higher than lifetime expected losses. For loan commitments, one view could be to consider they are at below-market interest rates on initial recognition (as the terms were fixed at a time where the loan commitment was not credit-impaired) and apply the 'higher of' test. Alternatively, one may consider that the guidance for financial assets may be applied by analogy to loans commitments. This would make sense as the standard treats loans that are drawn from a loan commitment as a continuation of the same financial instrument. For disclosure purposes, we believe such loan commitments and financial guarantees should also be reported as credit-impaired.

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[260] IFRS 9.2.1(g), 2.3
[261] IFRS 9.2.3(c), 4.2.1(d)

11 Revolving credit facilities

The 2013 ED specified that the maximum period over which ECLs are to be calculated should be limited to the contractual period over which the entity is exposed to credit risk.[262] This would mean that the allowance for commitments that can be withdrawn at short notice by a lender, such as overdrafts and credit card facilities, would be limited to the ECLs that would arise over the notice period, which might be only one day. However, banks will not normally exercise their right to cancel the commitment until there is already evidence of significant deterioration, which exposes them to risk over a considerably longer period. Banks and banking regulators raised concerns over this issue and the IASB responded by introducing an exception for revolving credit facilities and setting out further guidance as well as an example addressing such arrangements.

In outline, the revolving facility exception requires the issuer of such a facility to calculate ECLs based on the period over which they expect, in practice, to be exposed to credit risk. However, the words of the exception are not very clear and it has been discussed at all three ITG meetings. The IASB staff have also produced a webcast on the topic.

11.1 Scope of the exception

The guidance relates to financial instruments that 'include both a loan and an undrawn commitment component and for which the entity's contractual ability to demand repayment and cancel the commitment does not limit the entity's exposure to credit losses to the contractual notice period'.[263] Despite the use of the word 'both', the ITG agreed, in April 2015, that this guidance applies even if the facility has yet to be drawn down. It also applies if the facility has been completely drawn down, as it is the nature of revolving facilities that the drawn down component is periodically paid off before further amounts will be drawn down again in future.

The standard also describes three characteristics generally associated with such instruments:[264]

‣ They usually have no fixed term or repayment structure and usually have a short contractual cancellation period

‣ The contractual ability to cancel the contract is not enforced in day-to-day management, but only when the lender is aware of an increase in credit risk at the facility level

‣ They are managed on a collective basis

Products that are generally agreed to be in the scope of the exception include most credit card facilities and most retail overdrafts. However, even with these, some caution needs to be applied, since we understand that there are credit card facilities which do not enable the issuer to demand repayment and cancel the facility, and as such, would be out of scope.

What is less clear is the treatment of corporate overdrafts and similar facilities. It is relevant that all the ITG discussions as well as the webcast referred to credit cards and retail customers and not corporate exposures. The problem is partly that the guidance for the standard describes management on a collective basis as a characteristic that revolving facilities in the scope of the exception 'generally have', rather than a required feature, as listed in

The section contains special rules for revolving credit facilities, such as overdrafts and credit cards.

Whether the revolving facilities exception applies to corporate facilities depends on the facts and circumstances and requires judgement.

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[262] *Exposure Draft – Financial Instruments: Expected Credit Losses*, March 2013, para. 17.
[263] IFRS 9.5.5.20
[264] IFRS 9.B5.5.39

paragraph 5.5.20 of IFRS 9.[265] Some banks consider this is still a determining feature and that many of their corporate facilities are outside the scope of the exception because they are managed on an individual basis. Banks normally have a closer business relationship with their larger corporate customers than with most retail customers, and more data to manage the credit risk, such as access to regular management information. Other banks consider that facilities that are individually managed are still in the scope of the exception, notably because individual credit reviews are generally performed only on an annual basis (unless a significant event occurs). In addition, it is unclear exactly what is meant by 'managed on a collective basis' and where to draw the line between large corporates and smaller entities. It should be noted that, if a corporate facility is not deemed to be a revolving facility, but can be cancelled at short notice, the ECLs will be limited to those that arise over the notice period.

At its December 2015 meeting, the ITG discussed whether:

‣ Multi-purpose credit facilities, which have the ability to be drawn down in a number of different ways (e.g., as a revolving overdraft, a variable or fixed-rate loan (with or without a fixed term) or an amortising loan such as a mortgage) would fall within the scope exception

‣ The general characteristics identified in paragraph B5.5.39 of IFRS 9 should be considered to be required characteristics, or merely examples of typical characteristics

‣ The existence of a fixed term of the loan once drawn down would prevent a facility from falling within the scope exception

The ITG commented that:

‣ The supporting application guidance in paragraph B5.5.39 of IFRS 9 reinforces the features described in paragraph 5.5.20 of IFRS 9 by setting out general characteristics which, while not determinative, are consistent with those features.

‣ The Basis for Conclusions of IFRS 9 provides further context around the type of financial instruments that the Board envisaged would fall within the scope exception. In particular, the exception was intended to be limited in nature and it was introduced in order to address specific concerns raised by respondents in relation to revolving credit facilities that were managed on a collective basis. Also, it was understood that these types of financial instruments included both a loan and an undrawn commitment component and that they were managed, and ECLs were estimated, on a facility level; i.e., the drawn and undrawn exposure were viewed as one single cash flow from the borrower.[266]

‣ Consequently, both the drawn and undrawn components of these facilities were understood to have similar short contractual maturities, i.e., the lender had both the ability to withdraw the undrawn commitment component and demand repayment of the drawn component at short notice.

‣ An immediately revocable facility which has a fixed maturity (e.g., 5 years) would be consistent with the type of facility within the scope exception because the fixed term feature does not negate the lender's contractual right to cancel the undrawn component at any time. In contrast, an immediately revocable facility that has no fixed maturity, but when drawn, can take the form of a loan with a fixed maturity (i.e., once it has been

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[265] IFRS 9.B5.5.39
[266] IFRS 9.BC5.254-BC5.261

drawn, the lender no longer has the right to demand immediate repayment at its discretion) would not be consistent with the type of facility envisaged to be within the scope exception. This is because the fixed-term feature does negate the lender's contractual right to demand repayment of the undrawn component. However, regarding this characteristic, the ITG members also highlighted the following:

(a) An entity would first need to establish the unit of account to which the requirements of IFRS 9 should be applied. In this regard, they noted that, even if there was only one legal contract supporting a particular multi-purpose credit facility, there might be more than one unit of account to consider

(b) If the fixed-term feature was for a shorter period, judgement would be required in order to determine whether such a fixed-term feature would prevent a particular financial instrument from falling within the scope exception (e.g., whether the borrower could consider the exposure on the drawn and undrawn components to be one single cash flow).

▸ IFRS 7 requires an entity to explain, among other things, the assumptions used to measure ECLs. Within the context of multi-purpose credit facilities, such disclosures are likely to be important in order to meet the disclosure objectives (see section 14 below).

While, according to the ITG, the drawn and undrawn exposures are viewed as 'one single cash flow from the borrower', the standard's Basis for Conclusions is slightly clearer.[267] It states that the loan and undrawn commitment ' are managed, and ECLs are estimated on a facility level. In other words, there is only one set of cash flows from the borrower that relates to both components'. Hence, the drawn and undrawn elements of a revolving facility within the scope of the exception would normally be viewed as only one unit of account. The ITG discussion seems to suggest that a new unit of account would be recognised if a borrower chose to draw down on a multi-purpose facility in the form of a term loan, because this is the point where this specific drawn portion ceases to share the key characteristic of a revolving facility, i.e., the entity's contractual ability to demand repayment and cancel the commitment.

At its December 2015 meeting, the ITG discussed charge cards and how ECLs on future drawdowns should be measured if there is no specified credit limit in the contract. The ITG members considered a specific fact pattern where the bank has the ability to approve each transaction at the time of sale based on the customer's perceived spending capacity using statistical models and inputs such as spending history and known income.

The ITG members noted that, because the bank has the right to refuse each transaction at its discretion, and on the assumption that the bank actually exercises that right in practice, then:

▸ The contractual credit limit should be considered to be zero and consequently future drawdowns would not be taken into account.

▸ The facility described would not fall within the scope exception because there would be no undrawn commitment component (i.e., there is no firm commitment to extend credit).

However, the ITG members noted that their discussions focused on the very specific fact pattern presented and observed that the conclusion could differ in other situations.

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[267] IFRS 9.BC5.259

11.2 The period over which to measure expected credit losses

According to the standard, 'for such financial instruments, and only those financial instruments, the entity shall measure ECLs over the period that the entity is exposed to credit risk and ECLs would not be mitigated by credit risk management actions, even if that period extends beyond the maximum contractual period'.[268] In order to calculate the period for which ECLs are assessed, 'an entity should consider factors such as historical information and experience about:

(a) The period over which the entity was exposed to credit risk on similar financial instruments

(b) The length of time for related defaults to occur on similar financial instruments following a significant increase in credit risk

(c) The credit risk management actions that an entity expects to take once the credit risk on the financial instrument has increased, such as the reduction or removal of undrawn limits.'[269]

This wording in the standard is not easy to interpret or apply.

This following example illustrates the calculation of impairment for revolving credit facilities, based on Illustrative Example 10 in the Implementation Guidance for the standard.[270] For the sake of clarity, the assumptions and calculations have been adapted from the IASB example as it is not explicit on the source of the parameters and how they are computed. The example has also been expanded to show the calculation of the loss allowances. However, to simplify the example, we have continued to ignore the need to discount ECLs or whether the credit conversion factor would change if an exposure has significantly deteriorated in credit risk.

Example 23: Revolving credit facilities

Bank A provides credit cards with a one day cancellation right and manages the drawn and undrawn commitment on each card together, as a facility. Bank A sub-divides the credit card portfolio by segregating those amounts for which a significant increase in credit risk was identified at the individual facility level from the remainder of the portfolio. The remainder of this example only illustrates the calculation of ECLs for the sub-portfolio, for which a significant increase in credit risk was not identified at the individual facility level. At the reporting date, the outstanding balance on the sub-portfolio is £6,000,000 and the undrawn facility is £4,000,000. The Bank determines the sub-portfolio's expected life as 30 months (using the guidance set out above) and that the credit risk on 25 per cent of the sub-portfolio has increased significantly since initial origination, making up £1,500,000 of the outstanding balance and £1,000,000 of the undrawn commitment (see the calculation of the exposure in the table below).

To calculate its EAD, Bank A adds the amounts that are drawn at the reporting date and additional draw-downs that are expected in the case that a customer defaults. For those expected additional draw-downs, Bank A uses a credit conversion factor that represents the estimate of what percentage of that part of committed credit facilities that is unused at the reporting date would be drawn by a customer before he defaults. Using its credit models, the bank determines this credit conversion factor as 95 per cent. The EAD on the portion of facilities measured on a lifetime ECL basis is therefore £2,450,000, made up of the drawn balance of £1,500,000 and £950,000 of expected further draw-downs before the customers default. For the remainder of the facilities, the EAD that is measured on a 12-month ECL basis is £7,350,000, being the remaining drawn balance of £4,500,000 plus additional expected draw-downs for customers defaulting over the next 12 months of £2,850,000 (see the calculation for the EAD in the table below).

Bank A has estimated that the PD for the next 12 months is 5 per cent, and 30 per cent for the next 30 months. The estimate for the LGD on the credit cards in the sub-portfolio is 90 per cent. That results in lifetime ECLs of £661,500 and 12-month ECLs of £330,750 (see calculation for ECLs in the table below).

For the presentation in the statement of financial position, the ECLs against the drawn amount of £607,500 would be recognised as an allowance against the credit card receivables and the remainder of the ECLs that relates to the undrawn facilities of £384,750 would be recognised as a liability (see table below).

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[268] IFRS 9.5.5.20
[269] IFRS 9.B5.5.40
[270] IFRS 9 IG Example 10 IE58-IE65

Example 23: Revolving credit facilities (cont'd)

Determination made at facility level		Drawn	Undrawn	Total
Facility		£6,000,000	£4,000,000	£10,000,000
Exposure				
Subject to lifetime ECLs (25% of the facility has been determined to have significantly increased in credit risk)	25%	£1,500,000	£1,000,000	
Subject to 12-month ECLs (the remaining 75% of the facility)	75%	£4,500,000	£3,000,000	£7,500,000
Credit conversion factor (CCF) A uniform CCF is used irrespective of deterioration, which reflects that the CCF is contingent on default which is the same reference point for a 12-month and lifetime ECL calculation	95%			
EAD EAD for undrawn balances is calculated as exposure × CCF				
Subject to lifetime ECLs		£1,500,000	£950,000	£2,450,000
Subject to 12-month ECLs		£4,500,000	£2,850,000	£7,350,000
PD				
Exposures subject to lifetime ECLs	30%			
Exposures subject to 12-month ECLs	5%			
LGD	90%			
ECLs (EAD × PD × LGD)				
Exposures subject to lifetime ECLs		£405,000	£256,500	£661,500
Exposures subject to 12-month ECLs		£202,500	£128,250	£330,750
		£607,500 presented as loss allowance against assets	£384,750 presented as provision	£992,250

In the above calculations, we have used the same credit conversion factor, of 95%, for calculating the EAD, irrespective of whether it is an input for 12-month or lifetime ECLs. This is based on an assumption that the extent of future draw-downs in the event that the customer defaults does not differ depending on whether, at the reporting date, there had been a significant increase in credit risk. In practice, for many credit cards, the exposure in the event of default reaches close to the credit limit and may even exceed it. However, as discussed further below, the standard does not permit the use of a credit conversion factor of more than 100%. For this reason, the use of a conventional credit conversion factor model for estimating the EAD may need to be adjusted to comply with the standard.

We make the following observations:

▸ Example 10 of the standard (on which our Example 23 above is based), does not explain how the entity has concluded that 25% of the portfolio has significantly increased in credit risk. Collective assessment is discussed in section 5.5 above.

▸ Example 10 in the standard also does not show how the 30-month period was calculated.

The ITG in April 2015, discussed how to determine the appropriate period when measuring ECLs for a portfolio of revolving credit card exposures in stages 1, 2 and 3 and commented that:

▸ An entity's ability to segment and stratify the portfolio into different sections of exposures in accordance with how those exposures are being managed will be relevant. For example, an entity may be able to identify exposures with specific attributes that are considered more likely to default and, consequently, would have shorter average lives than those that are expected to continue performing (see 5.5 above).

▸ While IFRS 9 requires a period in excess of the maximum contractual period to be used when measuring ECLs, the fundamental aim was still to determine the period over which the entity is exposed to credit risk and an entity must consider all three factors set out in paragraph B5.5.40. Consequently, expected defaults or potential credit risk management actions such as reduction or removal of undrawn limits could result in a shorter period of exposure than that indicated by the historical behavioural life of the facility. That is, the time horizon is not the period over which the lender expects the facility to be used, but the period over which the lender is, in practice, exposed to credit risk.

At its December 2015 meeting, the ITG continued the discussion on how an entity should determine the maximum period to consider when measuring ECLs for revolving credit facilities. This divided into two sub-questions: when does this period start and when does it end?

With respect to the starting-point, the ITG members observed that the requirements of paragraph B5.5.40 of IFRS 9 do not alter the starting point of the maximum period to consider when measuring ECLs and consequently, the appropriate starting-point should be the reporting date.

With respect to the ending-point, ITG members focused on which credit risk management actions an entity should take into account and noted that:

▸ An entity should consider:

   (a) Only credit risk management actions that it expects to take rather than all credit risk management actions that it is legally and operationally able to take.

The period over which an entity is exposed to a revolving facility is limited by the credit mitigation actions it expects to take and whereby it will terminate or limit the credit exposure.

(b) Only those credit risk management actions that serve to mitigate credit risk and, consequently, actions that do not mitigate credit risk such as the reinstatement of previously curtailed credit limits should not be considered.

(c) All credit risk management actions that it expects to take and that serve to either terminate or limit the credit risk exposure in some way.

▸ An entity's expected actions must be based on reasonable and supportable information. In this regard, consideration should be given to an entity's normal credit risk mitigation process, past practice and future intentions.

▸ The ending-point could be limited by the expected timing of the entity's next review process, but only if the entity's normal business practice is to take credit risk mitigation actions as part of this review process. Consequently, it may not always be appropriate to use the timing of the entity's next review process as a basis for determining the ending-point.

▸ In respect of assets in stage 2, the probability of assets curing and defaulting would need to be taken into account when determining the maximum period to consider when measuring ECLs.

▸ It was noted that a distinction should be made between credit risk management actions such as the reinstatement of a previously curtailed credit limit (that should not be taken into account) and considering how a particular stage 2 exposure that has not yet been subject to any credit risk mitigation actions will develop. For example, an entity may have determined that there has been a significant increase in credit risk since initial recognition in respect of a particular exposure, but may not yet have taken any specific credit risk mitigation actions such as the curtailment or termination of the credit limit. In this case, consideration should be given to the possibility that the exposure may cure rather than default. In contrast, if an entity had taken credit risk mitigation action in respect of that exposure such as the curtailment of the credit limit, it would not be appropriate to take into consideration the possibility that the exposure may subsequently cure, resulting in a reinstatement of the previously curtailed credit limit when determining the maximum exposure period. In this regard, appropriate portfolio segmentation is crucial, in particular, in relation to financial assets in stage 2.

▸ There is only one maximum exposure period to consider, which applies equally to both the drawn and undrawn components of a revolving credit facility, which is consistent with the way in which the facility is managed. Nevertheless, in measuring ECLs, credit risk mitigation actions may affect the drawn and undrawn components differently. For example, when an entity cancels the undrawn component, the possibility of any future drawdowns is removed, whereas when an entity demands repayment of the drawn component the recovery period associated with that drawn exposure still needs to be considered in measuring ECLs.

▸ Ultimately, the estimation of the maximum period to consider would require judgement and the disclosure requirements of IFRS 7 (such as those explaining inputs, assumptions and estimation techniques in relation to ECLs) would be important (see 14 below).

In May 2017 the IASB issued a webcast, *IFRS 9 Impairment: The expected life of revolving facilities*. Like other IASB webcasts, this sets out the views of the speakers rather than the Board, but it will, nevertheless, be regarded as important educational material.

The webcast used the example of a portfolio of 100 similar facilities, 30 of which are expected to significantly increase in credit risk by the next credit review and, at the next credit review, based on past experience, five of these facilities will be cut. The key messages provided were:

▸ The entity should assume that the expected life of the portfolio will be limited by the period to the next credit review only for those five facilities. This is because the expected life can only be reduced to the next review date to the extent that mitigation actions are expected to occur.

▸ It is not necessary to know in advance which five facilities will be cut.

▸ The expected life of the other 95 facilities will be bounded by when they are expected to default or the point at which the facility is no longer used by the customer.

▸ Meanwhile, the expected life for the five facilities may be shorter than the time to the next review if they are expected to default.

▸ As discussed at the ITG, it will be necessary to segment the portfolio appropriately into groups of loans with similar credit and payment expectations in order to determine its expected life. If a facility is more likely to default, then it is also more likely to be subject to risk mitigation action.

▸ If the entity expects, based on past experience, to cut the facility only in part, by reducing the limit, then the life of the facility will be cut only for the portion of the facility that is expected to be withdrawn.

This example only looks forward to what it expects to happen by the time of the next credit review. Presumably it would be appropriate to extend the analysis, to look beyond this to subsequent reviews and further reductions in facilities expected in the future, to help determine the expected life of the remaining 95 facilities in the portfolio. This is illustrated by Example 24 below.

A second example in the webcast compared two entities: entity A only cancels undrawn facilities that deteriorate to a risk classification of 20, while entity B cancels any facility as soon as it deteriorates to a classification of 15 (and so lower risk than grade 20). It was concluded that, all else being equal, the expected life for entity A's portfolio will be longer than for entity B's portfolio.

It should be stressed that estimating the expected life of a revolving facility is of relevance mostly for those facilities that are measured using lifetime credit losses. The allowance for those assets in stage 1 will be calculated based only on losses associated with default in the next twelve months, which is likely to be the period used to measure ECLs unless the entity's risk mitigation activities indicate that a shorter period should be used.

How we see it

To recap, it would seem that a periodic credit review should normally be taken into account when assessing the period over which to measure losses *to the extent that* it is expected to result in actual limit reduction or withdrawal. Hence, for example, if, normally, 20% of facilities are withdrawn based on an annual review, then for 20% of the outstanding facilities, the period to measure losses should be limited by the timing of this next review. For the other 80% of the facilities, three things may happen: they may someday default, the facility may someday be reduced or withdrawn, or the borrower may someday cease to use the card. For the 80% it is necessary to model each of these possibilities, which means that the period over which to measure ECLs may extend for a number of years into the future. In this view, the standard's requirement for any facilities measured using lifetime ECLs can be simply summarised as 'how much do you expect to lose'? The length of the period over which losses are measured is of secondary importance except that it is necessary to know when defaults are expected to occur, in order to determine the appropriate discounting.

The application of this approach is illustrated in the following example.

Example 24: Estimating the life of revolving credit facilities

Of 1,000 facilities in stage 2 the entity estimates that each year:

▸ 10% will default every year in the first three years, but this reduces to 2% thereafter, as those facilities that do not default in the first three years are expected to have become significantly lower risk.

▸ 8% of holders will cease to use their card every year in the first three years, but this increases to 15% thereafter once their financial position has improved.

▸ 15% of facilities will be withdrawn each year, as credit risk mitigation, over the first three years. After that period, it is assumed that the credit risk is significantly reduced and none of the facilities are reduced thereafter.

	No. of facilities in Stage 2						
Balance brought forward	1,000	670	448	301	250	207	172
Defaults	(100)	(67)	(45)	(6)	(5)	(4)	(3)
Cease to use card	(80)	(54)	(35)	(45)	(38)	(31)	(26)
Facility withdrawn	(150)	(101)	(67)	–	–	–	-
Balance carried forward	670	448	301	250	207	172	143

In this example, it is apparent that while the level of defaults quickly declines, a small portion of the portfolio has a very long life. The consequence is that the ECL could be very significant. However, the example does not take account of the time value of money. Given the high interest rate charged on credit cards, the manner in which interest is included in the estimation of cash flows and losses are discounted will have a major impact upon the ECL measurement (see section 11.4 below).

One method that we have observed being applied to make this calculation work is to track a portfolio of stage 2 facilities over a number of years and note how long it takes for the default rate to reduce to an immaterial level.

> It is less clear how the rules for revolving facilities interact which those for derecognition.

A further issue is the extent to which the period over which to measure ECLs is restricted by the normal derecognition principles of IFRS 9 and what could constitute a derecognition of the facility. In particular, it is unclear whether the existence of a contractual life and/or the lender's ability to revise the terms and conditions of the facility based on periodic credit reviews as thorough as that on origination, would be regarded as triggers for derecognition and so would also limit the life for ECL measurement.

In April 2015, the ITG discussed how to determine the date of initial recognition of a revolving credit facility for the purposes of the assessment of significant increases in credit risk. The challenge presented was how to determine when changes are sufficiently significant to result in a derecognition of the original facility and recognition of a new facility. The ITG members discussed some of the factors that might be taken into consideration in making that judgement, such as issuing a new card, revising credit limits or conducting credit reviews.

It was noted that judgement would be required in making this assessment and that it would depend on the specific facts and circumstances. However, the following observations were made:

(a) In some circumstances issuing a new card may be indicative that the original facility has been derecognised, but, in other cases, this may be a purely operational process and thus would not indicate that a new facility has been issued

(b) Credit reviews in themselves may not indicate that a new facility has been issued

Although this discussion was on how to determine the reference date for assessing if there has been a significant increase in credit risk, the notion that it depends on the derecognition of one facility and the recognition of a new one would, presumably, be equally relevant for assessing the period over which to measure ECLs. This is especially relevant for corporate overdraft facilities which are considered to be in the scope of the exception (see 11.1 above). If, for instance:

i) The facility has a clearly agreed contractual life of one year (in addition to a short cancellation notice period)

ii) The bank goes through a thorough credit process each year, similar to that on original application and using detailed financial and other information specific to the customer, before deciding whether to continue with the facility, increase it, reduce it or withdraw it

iii) The bank will at that time revise the terms and conditions of the facility to reflect the up-to-date credit quality of the borrower

iv) The bank derecognises the facility and recognises a new one, giving the associated required disclosures

Intuitively, it would seem that the bank is only exposed to credit risk for the period of a year.

This is consistent with the Basis of Conclusions which confirms the general principle that, 'if an entity decides to renew or extend its commitment to extend credit, it will be a new instrument for which the entity has the opportunity to revise the terms and conditions.'[271] Also, while paragraph BC5.261, by starting with the word 'however', makes it clear that the revolving facilities amendment was an exception to this principle, it does not explicitly state that it is an exception to the entire principle. On one hand, it states that 'the entity's contractual ability to demand repayment and cancel the undrawn commitment does not limit the entity's exposure' (emphasis added), remaining silent on an entity's ability to renew or extend credit. On the other hand, some believe that an ability to withdraw or cancel is, in substance, sufficiently similar to an ability to renew or extend, and that they should be treated the same. They also consider that the IASB webcast has made it clear that only expected reductions and withdrawals of facilities can be reflected in the assessment of the risk horizon. Consequently, a decision to maintain the facility, even if based on fully revised terms and conditions, would not be considered a risk management decision that shortens the life of the facility.

There are also differences of view as to whether a revolving facility can be derecognised (and so the expected derecognition can be reflected in the ECL horizon) if the lender carries out an annual thorough periodic credit review at least equivalent to that when the facility was first granted. At this point, the lender may revise the terms and conditions, but there is no contractual limit to the life of the facility, or if there is a contractual limit to the life of the facility but no thorough credit review at the point of renewal. In the first case, the contract allows for a periodic credit review equivalent to that on origination, to be performed on an individual rather than a collective basis and with an opportunity to revise the terms and conditions if the credit quality has changed, some believe that this could lead to derecognition of the facility and recognition of a new one. As a result, ECLs would only be measured over the period until the next periodic review. In the second case, the facility has a clearly agreed contractual life, but its renewal is relatively automatic without a thorough review. Some believe that IFRS 9 is clear that a financial instrument is derecognised if it expires and therefore a thorough credit review is not required.

It will be important for banks to disclose the basis on which they have made their calculations.

It should be stressed that this issue is of relevance mostly for those facilities that are measured using lifetime credit losses. The allowance for those assets in stage 1 will be calculated based only on losses associated with default in the next twelve months.

11.3 Exposure at default (EAD)

To measure ECLs on revolving facilities, such as credit cards, it will be necessary to estimate several components that make up the EAD:

▸ The credit conversion factor, to determine the portion of the facility that is drawn down in any period (limited, for facilities in stage 1 to the next twelve months)

▸ The speed at which drawn down facilities are paid off

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[271] IFRS 9.BC5.260

▸ The level of interest expected to be charged in the future on those facilities that are drawn down

These components will all need to be estimated based on past experience and future expectations, for sections of the portfolio that are segmented so that they have similar credit characteristics (see section 5.5.2 above). The estimation of interest is addressed further in section 11.4 below.

At its meeting on 16 September 2015, the ITG (see section 1.5 above) discussed 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 overdrafts and other revolving credit facilities.

The ITG members noted that:

▸ The exception for some types of revolving credit facilities set out in paragraph 5.5.20 of IFRS 9 relates to the contractual commitment period and does not address the contractual credit limit. The standard was clear in this regard. Consequently, it would not be appropriate to analogise this specific exception to the contractual credit limit.

▸ Some members of the ITG pointed out that, in practice, the tenor and amount of revolving credit facilities are inextricably linked, because banks not only extend credit for a period in excess of their maximum contractual commitment period, but also allow customers to make drawdowns in excess of the maximum contractually agreed credit limit as notified to the customer. Consequently, if amounts in excess of the maximum contractually agreed credit limits are not taken into account, there would be a potential disconnect between the accounting and credit risk management view.

▸ However, it was concluded that IFRS 9 limits the estimation of future drawdowns to the contractually agreed credit limit

11.4 Time value of money

The time value of money is important in measuring ECLs for revolving facilities since interest rates (when interest is charged) are high. Hence, it is important that any interest that is expected to be charged on drawn balances is included in the EAD and that an appropriate rate is used to discount ECLs. An additional complexity is introduced by credit cards, because they typically have a grace period in which no interest is charged as long as the amount drawn down is repaid within a specified period of time.

The standard is silent on this topic, however, the ITG discussion on the use of floating-rates of interest to measure ECLs in December 2015 (see section 4.7 above) established a useful principle that there should be consistency between the rate used to recognise interest revenue, the rate used to project future cash flows (including shortfalls) and the rate used to discount those cash flows. While the high rates charged by a credit card issuer are sometimes fixed in the contract, the fact that the rate charged (nil or the high rate) depends on how quickly the customer repays the amount drawn, means that the rate can be thought of as 'floating', even if it does not vary with a benchmark rate of interest. This is important since, otherwise, it would be necessary to assess the EIR on original recognition and keep this fixed unless the facility is derecognised, ignoring any changes in customer behaviour.

Applying this principle, for a credit card customer that is a 'transactor', that is, one who repays any amount drawn down within the specified short period and so is charged no interest, it would not be appropriate to discount expected losses. On the other hand, for a credit card customer

The EAD on revolving facilities is limited to the contractual limit.

The time value of money may have a major impact on the measurement of ECLs for revolving facilities.

who is a 'revolver' and who only pays off the minimum amounts permitted by the issuer (in effect, using the card to borrow money), the high rate of interest should be included in the forecast cash flows and in the discount rate.

However, any transactor who goes on to default is likely to begin paying off less than the full amount for a period of time before they default. To estimate the expected losses for this scenario, it will be necessary to include any interest that will be charged in this period. A consistent discount rate will then be a blended rate of nil for the period over which the customer is expected to pay no interest and the high rate over the period in which they will pay.

According to the guidance for 'normal' loan commitments, the expected credit losses on a loan commitment must be discounted using the effective interest rate, or an approximation thereof, that will be applied when recognising the financial asset resulting from the loan commitment.[272] Applying this approach, the losses on the currently undrawn portion of a revolving facility should be discounted based on the rate that is likely to be charged if it is drawn down. If it is expected that interest will be charged at the high rate – which is likely for most facilities that are already 'revolvers' – then the discount rate is likely to be the high rate. This approach is consistent with a view expressed at the ITG meeting that the drawn and undrawn balances should be viewed as one unit of account and so discounted at the same rate. If it is projected that a transactor will at some stage become a revolver before it defaults, then it may be appropriate to calculate a blended discount rate.

Because the choice of interest rate used to project cash flows and to discount losses will depend on expectations of the borrower's behaviour, it will need to be made separately for segments of the portfolio with similar credit and payment characteristics.

How we see it

In practice, it is likely that credit card issuers will often adopt procedures to discount their ECLs that may be less sophisticated than set out above, due to operational constraints and because the objective of the standard is to discount ECLs at *an approximation* of the EIR.[273] However, it is necessary to understand what is theoretically required by IFRS 9 in order to be able to assess whether a pragmatic approach is a reasonable approximation.

11.5 Determining significant increase in credit risk

As already mentioned at section 11.2 above, at its April 2015 meeting, the ITG discussed the starting reference date when assessing significant increases in credit risk for a portfolio of revolving credit facilities. There will typically be a diverse customer base, ranging from long-standing customers who have been with the bank for many years, to new customers who have only recently opened an account. The general rule in IFRS 9 is that the starting reference date is the date of original recognition. Consequently, the date of initial recognition for this purpose is the date the facility was issued and it should only be changed if there has been a derecognition of the original facility. As discussed at section 11.2 above, it is not altogether clear what would qualify as a derecognition within the context of the revolving facility exception. If the lender derecognises

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[272] IFRS 9.B5.5.47
[273] IFRS 9.B5.5.44

a facility at the end of its contractual term and recognises a new one when it decides to renew or extend credit, in line with the Basis of Conclusions, it would be consistent to assess if there has been a significant increase in credit risk from when the current facility was first recognised.[274] Similarly, it may make sense to use the date that the limit was increased if a facility is now far larger than would have been granted on original recognition. There is also a view that the credit risk on the date that the facility was last increased may be a useful proxy for the credit risk on the date of original recognition. There is a particular challenge on transition to IFRS 9, since entities may have limited data on the credit risk at the date of original recognition (see section 4.8 above).

However, as discussed at section 11.2 above, another view is that only a reduction or cancellation of the facility would lead to the revolving facility being derecognised. In some circumstances, issuing a new card may be indicative that the original facility has been derecognised (e.g., replacement of a student credit card with a new credit card upon graduation), but in other cases, this may be a purely operational process and thus, would not indicate that a new facility has been issued.

The ITG did not conclude further on this issue and it was not discussed in the IASB's May 2017 webcast. Consequently, at the date of writing, this issue had not been resolved.

12 Intercompany loans

For those entities that prepare stand-alone IFRS financial statements, or consolidated financial statements for part of a wider group, one of the challenges in complying with the IFRS 9 impairment requirements is the application to intercompany loans.

> The first problem with intercompany loans is that they are often undocumented and advanced on non-arm's length terms.

Many intercompany loans are structured so as to be on an arm's length basis, often for tax purposes, or because they involve transactions with special purpose entities (SPEs) that are consolidated because the group retains control. For these loans, application of IFRS 9 will be similar to loans to third parties. It is more likely that these loans are clearly documented and priced at market rates which will reflect the PD and LGD. One of the challenges for applying IFRS 9 to intercompany loans is that money is often lent by one group company to another on terms that are not 'arm's length' or even without documented terms at all. It is strongly recommended that the implementation of IFRS 9 is used as an opportunity to determine the terms of such arrangements and document them so as, where possible, to reflect their substance. This is because it is particularly difficult to apply IFRS 9 to arrangements where the terms are unknown or the legal form (if documented) differs from their substance. Examples of the latter include:

1) Loans that may be documented as on demand, and interest free, but which are intended to be either a capital investment unlikely to be repaid, or a loan to be repaid after a number of years.

2) Loans that are structured between group companies on terms whereby there is an implicit guarantee of credit risk by a parent company, but this is never explicitly documented.

In some cases (subject, of course, to consideration of the implications for tax and distributable profits), it may be possible to restructure intercompany arrangements on an arm's length basis (and document them accordingly) and so better enable the application of the standard.

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[274] IFRS 9.BC5.260

All intercompany loans are in the scope of IFRS 9. It is possible that a group company is financed entirely by debt rather than partly through equity, so that the substance of the loan (at least in part) may be closer to an equity investment in that company. This raises the question as to whether loans to group companies can ever be regarded as an 'investment' in them, which could be accounted for under IAS 27 *Separate Financial Statements* at cost, rather than a loan accounted for under IFRS 9. 'Investments' are not defined for this purpose. Although IAS 27 is usually read to refer to investments in shares, an argument might be made that it can also cover intercompany arrangements which are, in substance, capital investments. However, the IFRS Interpretations Committee (IFRIC) in September 2016 seem to have ruled against this. IFRIC discussed the interaction of IFRS 9 and IAS 28 *Investments in Associates and Joint Ventures*, when a loan is regarded as part of 'long-term interests that, in substance, form part of the entity's net investment' as set out in paragraph 38 of IAS 28, which gives as an example, 'an item for which settlement is neither planned nor likely to occur in the foreseeable future'. IFRIC concluded that although a loan is considered as 'in substance part of the investment', for the purposes of allocating losses in IAS 28, it is still in the scope of IFRS 9 as it is not 'an investment', as mentioned in scope paragraph 2.1 (a) of IFRS 9 and, except for the allocation of losses, is not accounted for using the equity method. Since then, in October 2017, the IASB amended IAS 28 to clarify that IFRS 9 should be applied to long-term interests in associates and joint ventures.

How we see it

The IFRIC discussion on long-term interests in associates was in the context of IAS 28 and not IAS 27. It is perhaps relevant that IFRS 9 in its scope paragraph refers to 'interests' in subsidiaries, rather than 'investments', although IAS 27 itself uses 'investments'. IAS 27 also allows investments to be at cost, rather than accounted for using the equity method. However, it would probably be difficult to sustain an argument that 'investments' as used in IAS 27, encompasses loans which are, in substance, part of the net investment, when the IFRIC has concluded that the same term in IAS 28 does not.

Having said that, an undocumented interest free loan to a subsidiary, when there is no expectation of repayment, may, in substance, be more like a capital contribution. If this is the case, then it will be helpful to document it as such (with the features of equity) and then it may be measured at cost and subject to the impairment requirements of IAS 36 *Impairment of Assets* – rather than those of IFRS 9. The amendment of a loan (if previously documented as such) to a capital contribution would be similar to a forgiveness of the debt and so, as already mentioned above, may have implications for (or be constrained by) tax and may only in future be capable of being repaid if there are adequate distributable profits.

Another example of where it may be helpful to restructure (and so amend the documented terms of) loans is where a subsidiary is only financed by loan capital and there is little or no equity capital, a situation that tax experts refer to as 'thinly capitalised'. Interest paid on a portion of the loan may be disallowed for tax purposes, reflecting that a portion of the loan is, in substance, the subsidiary's capital. The requirements of IFRS 9 may make it worthwhile for such loans to be restructured (and the new terms documented), so that

Not all intercompany loans may qualify to be measured at amortised cost.

Most intercompany loans will qualify to be measured at amortised cost since they are held in a business model to collect the cash flows rather than to sell the loan and they normally have features which represent solely payments of principal and interest. Loans which may provide greater challenges include:

▸ Some loans pay no interest, even though they are not expected to be repaid for a number of years. If they are not repayable on demand, then these will normally be recognised initially at fair value and so at less than par. The discount will then be accreted to par as part of the EIR. Consequently, they are deemed to pay interest and so may satisfy the SPPI criterion.

▸ Loans that are 'non-recourse', in which repayment of the loan is either contractually or implicitly dependent on the performance of an asset, or assets, held by the subsidiary. This is most likely to be an issue for loans to SPEs or other related parties such as joint ventures, where there is insufficient equity capital to absorb the likely variability of cash flows of the underlying asset(s). This problem is equivalent to the 'thin capitalisation' issue, described above. Such non-recourse loans are required to be measured at fair value through profit or loss.

All financial assets within the scope of IFRS 9 must be measured on initial recognition at fair value. This means that an interest free loan, or a loan at below a market rate of interest, will need to be recognised initially at less than its nominal value unless it is repayable on demand. This criterion would require both that the lender may legally call the loan and that it is expected that the subsidiary would be able to repay the loan if called. The fair value of the loan on initial recognition will normally reflect the economics of the arrangement. The loan will then accrete in value over its expected life, and so will compensate the lender for the time value of money and credit risk, and so qualify to be recorded at amortised cost.

If the fair value of the loan when first recorded is less than the par value, the accounting for the difference will depend on whether the loan is to a subsidiary, a fellow subsidiary, or a parent. If the loan is to a subsidiary, the difference will normally be recorded as a capital contribution, which will be outside the scope of IFRS 9. If the loan is to a fellow subsidiary, or to a parent, it will normally be recorded as a distribution of capital to the parent.

It should be stressed that any ECLs measured on a loan to a group company will require a charge to profit or loss; the expense cannot be capitalised as part of the investment in a subsidiary.

Compared to most loans to third parties, a lender within a group is likely to have access to much more qualitative and quantitative information about the credit risk of the borrower. Consequently, the staging assessment is likely to be much better informed than for a third party loan and will be, primarily, a qualitative exercise. In many cases, it will be reasonably clear whether there has been a significant increase in credit risk since the loan was first made, although there will still be a judgement to be made as to what is 'significant'. Circumstances that indicate a significant increase in credit risk may include a significant change in the business, financial or economic conditions, or regulatory, economic or technological environment in which the borrower operates, declining revenues

and margins, or capital deficiencies, in each case that are likely to have a significant impact on the entity's ability to meet its debt obligations.[275]

Also, the credit risk on a loan depends, in part, on the level of loss absorbing equity of the borrowing entity. If the parent of a group company commits to support a distressed subsidiary (in advance of becoming distressed) by injecting new equity, this may mean that there is no significant increase in the credit risk of the loan.

How we see it

It is probably fair to say that much less attention has been paid to how to calculate ECLs on intercompany loans than on other aspects of IFRS 9. However, we make the following observations:

a) As long as group companies are adequately capitalised, most intercompany loans will be in stage 1 and, so, will require an allowance equal to the 12 month ECLs.

b) Those balances that are genuinely repayable on demand will attract a negligible ECL, since ECLs are only measured over the period in which the entity is exposed to credit risk. However, if the loan is incapable of being repaid on demand, such that the borrower would default if the loan were called, the probability of default would probably need to be set to 100%. However, even though the PD may be 100%, the LGD may be much lower if the lender can expect, in due course, to recover most or all of the amount of the loan once the underlying assets are realised.

c) For those stage 1 intercompany loans that are term loans with a maturity greater than 12 months, it will be necessary to determine the 12-month PD and the LGD. This will often be difficult given that there will be no statistical basis to do so. It will be easier to assess a PD – and for it to be reasonably low – if the borrower is adequately capitalised relative to the risks it faces, so that it could raise funding from a third party.

d) For those intercompany loans between fellow subsidiaries that are guaranteed by a parent which is listed (and the guarantee is considered to be part of the loan's contractual terms (see 4.8.1 above)), the expected loss will normally be equal to the parent's PD multiplied by its LGD, since the parent will usually ensure, if it can do so, that its subsidiary will not default (and the subsidiary is also likely to default if the parent does). It will often be much easier to calculate an ECL based on a parent PD and LGD, since there may be bond spreads, CDS spreads and credit ratings to draw upon. It may, therefore, be advisable to document guarantee arrangements when this is already the implicit basis on which the loan was given. However, it may be that the parent has no other activities other than acting as a holding company, in which case, its PD will be closely aligned with that of its subsidiaries. There will also be cases where the subsidiary can be expected to survive even if the parent defaults.

e) To the extent that the lender is the parent, it cannot, for its own accounting purposes, rely on guarantees given to itself. Meanwhile, any entity that does provide a guarantee will need to measure its exposure to the guarantee, hence the existence of a guarantee

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[275] IFRS 9.B5.5.17 (f), (g), (i)

13 Presentation of expected credit losses in the statement of financial position

IFRS 9 uses the term 'loss allowance' throughout the standard as an umbrella term for ECLs that are recognised in the statement of financial position. However, that umbrella term leaves open the question of how those ECLs should be presented in that statement. Their presentation differs by the type of the credit risk exposures that are in scope of the impairment requirements.[276] This section explains how presentation applies in the different situations.

Any adjustment to the loss allowance balance due to an increase or decrease of the amount of ECLs recognised in accordance with IFRS 9, is reflected in profit or loss in a separate line as an impairment gain or loss.[277]

13.1 Allowance for financial assets measured at amortised cost, contract assets and lease receivables

ECLs on financial assets measured at amortised cost, lease receivables and contract assets are presented as an allowance, i.e., as an integral part of the measurement of those assets in the statement of financial position.

Unlike the requirement to show impairment losses as a separate line item in the statement of profit or loss, there is no similar consequential amendment to IAS 1 to present the loss allowance as a separate line item in the statement of financial position.[278]

It is clear from the standard that the definition of *amortised cost* of a financial asset refers to after it has been adjusted for any loss allowance and hence, the loss allowance would reduce the *gross carrying amount* in the statement of financial position (which is why an allowance is sometimes referred to as a contra asset account).[279] Accordingly, financial assets measured at amortised cost, contract assets and lease receivables should be presented net of the loss allowance at their amortised cost in the statement of financial position.

A write-off is considered a derecognition event.

This was confirmed at the ITG meeting in December 2015, when the ITG discussed whether an entity is required to present the loss allowance for financial assets measured at amortised cost (or trade receivables, contract assets or lease receivables) separately in the statement of financial position. The ITG members first noted that, irrespective of how the loss allowance is presented or how it is included in the measurement of the financial instrument, IFRS 7 contains disclosure requirements pertaining to the loss allowance for all financial instruments within the scope of the IFRS 9 impairment requirements. The ITG members also noted that, in contrast to the case of financial assets measured at fair value through other comprehensive income, neither IFRS 9 nor IFRS 7 contains any specific requirements regarding the presentation of the loss allowance for financial assets measured at amortised cost (or trade receivables,

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276 *IFRS 9 Appendix A*
277 IAS 1.82(ba), IFRS 9.5.5.8, Appendix A
278 IAS 1.82(ba)
279 IFRS 9 Appendix A

contract assets or lease receivables) on the face of the statement of financial position. In accordance with the general requirements of IAS 1, the financial statements should fairly present the financial position of an entity. However, the ITG members noted that paragraph 54 of IAS 1 does not list the loss allowance as an amount that is required to be separately presented on the face of the statement of financial position.

13.1.1 Write-off

IFRS 9 provides guidance on when the allowance should be used, i.e., when it should be applied against the gross carrying amount of a financial asset. This occurs when there is a write-off on a financial asset, which happens when the entity has no reasonable expectations of recovering the contractual cash flows on a financial asset in its entirety or a portion thereof. A write-off is considered a derecognition event.[280] No similar guidance is provided in IAS 39 and its derecognition guidance does not refer to write-offs.

For example, a lender plans to enforce the collateral on a loan and expects to recover no more than 30 per cent of the value of the loan from selling the collateral. If the lender has no reasonable prospects of recovering any further cash flows from the loan, it should write off the remaining 70 per cent.[281] The example given in the standard demonstrates that write-offs can be for only a partial amount instead of the entire gross carrying amount.

If the amount of loss on write-off is greater than the accumulated loss allowance, the difference will be an additional impairment loss. In situations where a further impairment loss occurs, the question has arisen as to how it should be presented: either simply as a loss in profit or loss with a credit directly to the gross carrying amount; or as an addition to the allowance that is then applied against the gross carrying amount. The difference between those alternatives is whether the additional impairment loss flows through the allowance, showing up in a reconciliation of the allowance as an addition and a use (i.e., a write-off), or whether such additional impairment amounts bypass the allowance. The IASB's original 2009 ED (see section 1.1 above) explicitly mandated that all write-offs could only be debited against the allowance, meaning that any direct write-offs against profit or loss without flowing through the allowance were prohibited.[282] IFRS 9 does not include any similar explicit guidance on this issue (see section 7.1 above in relation to presentation of modification losses).

Similarly, the standard does not provide guidance on accounting for subsequent recoveries of a financial asset. Arguably, there would be a higher threshold when recognising an asset that has been previously written-off and this is likely to be when cash is received rather than when the criteria for write-off are no longer met. It might also be argued that such recoveries should not often be significant, as write-off should only occur when there is no reasonable expectations of recovering the contractual cash flows. As the nature of recoveries are similar to reversals of impairment, it makes sense to present such recoveries in the impairment line in profit or loss as it would provide useful and relevant information to the users of the financial statements.[283]

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[280] IFRS 9.5.4.4, B3.2.16(r)
[281] IFRS 9.B5.4.9.
[282] *Exposure Draft – Financial Instruments: Amortised Cost and Impairment*, November 2009, para. B23.
[283] IAS 1.82(ba)

In addition, IFRS 7 requires an entity to disclose its policies in relation to write-offs and also, the amounts written off during the period that are still subject to enforcement activity (see section 14).[284] It should be noted that there is a tension between this requirement and the criteria in IFRS 9 for write-offs, since it may be difficult to argue that there is no reasonable expectation of recovering the contractual cash flows if the loan is still subject to enforcement activity.

13.1.2 Presentation of the gross carrying amount and expected credit loss allowance for credit-impaired assets

For financial assets that are not purchased or originated credit-impaired, but subsequently have become credit-impaired (i.e., moved to stage 3), the application of the EIR to the financial asset's amortised cost, i.e., the gross carrying amount net of the ECL allowance, applies only to the calculation and presentation of interest revenue in subsequent reporting periods.[285] The Basis for Conclusions confirms that this does not affect the measurement of the loss allowance.[286] As long as the asset was not credit-impaired on initial recognition, the EIR is based on the contractual cash flows, excluding ECLs and this does

not change when the asset becomes credit-impaired.[287] Consequently, the calculation of the gross carrying amount and the ECL allowance are not affected by the recognition of interest revenue moving from a gross to a net basis.

During its meeting in December 2015, the ITG discussed the measurement of the gross carrying amount and loss allowance for credit-impaired financial assets that are measured at amortised cost (excluding those that are purchased or originated credit-impaired). Interest revenue for credit-impaired financial assets is required to be reported in profit or loss based on the original EIR multiplied by the amortised cost (i.e., the gross carrying amount less the loss allowance). A question was raised on how the disclosed figures for the gross carrying amount and loss allowance should each be calculated. The example below is based on the ITG discussion, but has been amended to reflect unpaid accrued interest in the gross carrying amount.[288]

> For stage 3 loans, the disclosed gross amount and the allowance each need to be grossed up for the accrual of interest.

Example 25: Disclosing the gross carrying amount and loss allowance for credit-impaired financial assets that are not purchased or originated credit-impaired

The Bank originated a loan on 1 January 2018, with an amortised cost of $100 and an EIR of 10% per annum. On 31 December 2018, the loan is considered to be credit-impaired and so is moved to stage 3, and an impairment allowance is recognised of $70. Accordingly, the gross carrying amount of the loan is now $110 and the amortised cost is now $40. During 2019, no cash is received, and on 31 December 2019, there is no change in the expected cash flows. Accordingly, the amortised cost becomes $44 (being $40 + ($40 × 10%)). Three different ways could be used to reflect the changes in the net amortised cost in the gross carrying amount and the loss allowance. In Approach A, interest continues to be accrued in the measurement of the gross carrying amount at 10%, in Approach B, the interest accrued to the gross carrying amount is only the $4 recorded in profit or loss, while in Approach C, no interest is added to the gross carrying amount:

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[284] IFRS 7.35F(e), 35L
[285] IFRS 9.5.4.1(b)
[286] IFRS 9.BC5.75
[287] IFRS 9.B5.4.4, Appendix A
[288] Transition Resource Group for Impairment of Financial Instruments, Agenda ref 9, *Measurement of the loss allowance for credit-impaired financial assets*, 11 December 2015.

Approach	A	B	C
	$	$	$
Gross carrying amount	121*	114	110
Loss allowance	(77)	(70)	(66)
Amortised cost	44	44	44

* The gross carrying amount is calculated by adding the EIR of 10% per annum on the 31 December 2018 gross carrying amount of $110, i.e., 10% × $110 = $11.

It was acknowledged by the ITG members that IAS 39 provides no specific guidance on this matter and that there is diversity in current practice.

The ITG members appeared to agree that only Approach A is IFRS 9-compliant. Thereby, for assets in stage 3, it is necessary to 'gross up' accrued interest income, to increase both the disclosed gross carrying amount and loss allowance in the notes to the financial statements. This is because IFRS 9, unlike IAS 39, defines the gross carrying amount. Approach A requires the entity to calculate:

(a) The gross carrying amount by discounting the estimated contractual cash flows (without considering ECLs) using the original EIR

(b) The loss allowance by discounting the expected cash shortfalls using the original EIR

This conclusion has caused some discussion. Some have pointed out that, assuming no further loss is expected, this results in an increase in the amount of the impairment allowance over time that is not presented as an impairment loss, even though all movements in the allowance are required by IAS 1 to be reported in a separate line in the income statement.[289] Presumably the IASB considers the requirements of IFRS 9 to be more relevant, since it is specific on how the gross carrying amount is defined and how interest should be recognised. However, it would be useful for IAS 1 to be amended so as to be consistent.

Depending on the legal form of the loan, we assume that, once interest is no longer contractually due, for instance, when the bank moves to take possession of collateral, there would be no need to continue to make these gross-up entries.

In addition, the gross carrying amount, as required to be disclosed, is not the same as the amount normally required by banking regulators to be disclosed as 'non-performing loans' and used as a key reporting metric by banks. This is because such measures do not normally continue to accrue interest once they default, if no further interest is expected to be received. Banks may, therefore, wish to add further disclosure, as illustrated by Example 26 below:

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[289] IAS 1.82

Example 26: Disclosing the gross carrying amount and loss allowance for credit-impaired financial assets that are not purchased or originated credit-impaired and the value of non-performing loans

The fact pattern is the same as in Example 25 above.

The bank has a policy of disclosing its non-performing loans measured without accruing interest. The following approach is designed to disclose both methods of reporting the loans as of 31 December 2019.

Non-performing loans	$100
Accrued interest	$21
Gross carrying amount	$121
Loss allowance	($77)
Amortised cost	$44

The IASB is of the view that, conceptually, an entity should assess whether financial assets have become credit-impaired on an ongoing basis, thus, altering the presentation of interest revenue as the underlying economics change. However, the IASB noted that such an approach would be unduly onerous for preparers to apply. Thus, it decided that an entity should be required to make the assessment of whether a financial asset is credit-impaired at the reporting date and then change the interest calculation from the beginning of the following reporting period.[290] Arguably, if an entity is able to change the interest calculation earlier than the reporting date, then this would be a timelier adjustment and reflection of the interest revenue. However, this is not what the standard requires.

If there are subsequent improvements in the credit risk of the financial asset such that it is moved back to stage 2, there should not be any catch-up adjustments to the interest revenue recognised in a subsequent reporting period unless there are changes in expected cash flows. This is illustrated in the example below:

Example 27: Presentation of the interest revenue, gross carrying amount, loss allowance and amortised cost for when assets move from stage 2 to stage 3 and vice versa

Based on the fact pattern in Example 25 above, for the reporting period to 31 December 2018, the interest revenue would be calculated by applying the 10% EIR to the gross carrying amount of the loan of $100, i.e., $10. For the subsequent reporting period to 31 December 2019, the interest revenue would be calculated by applying the 10% EIR to the amortised cost of the loan of $40, i.e., $4, instead of the gross carrying amount.

During 2020, the credit risk of the loan improves and the contractual interest for 2018, 2019 and 2020 of $33 (including interest on interest) is received at the beginning of 2021. At the end of 2020, the loan is transferred to stage 2 and the ECL is reduced to $40. For the next reporting period to 31 December 2021, the interest revenue would be calculated by applying the 10% EIR to the gross carrying amount of the financial asset once the backlog of interest has been received of $100, i.e., $10. It is assumed that the ECL is left unchanged during 2021 except for the unwind of the discount.

Consistent with the treatment of interest income when an asset first becomes credit impaired, we have restored the recognition of interest income to the EIR multiplied

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[290] *IFRS 9.BC5.78*

by the gross amortised cost only from the start of the next reporting period.

	31 December 2018	31 December 2019	31 December 2020	31 December 2021
	$	$	$	$
Gross carrying amount				
As at 1 Jan	100	110	121	133
Interest accrued (EIR) on the gross carrying amount	10	11	12	10
Interest received	–	-	-	(33)
As at 31 Dec	110	121	133	110
ECL allowance				
As at 1 Jan	-	70	77	40
Impairment	70	-	(45) 8	4
Adjustment to interest accrued	-	7		-
As at 31 Dec	70	77	40	44
Amortised cost				
As at 1 Jan	$100	$40	$44	$93
As at 31 Dec	$40	$44	$93	$66

13.2 Provisions for loan commitments and financial guarantee contracts

In contrast to the presentation of impairment of assets, ECLs on loan commitments and financial guarantee contracts are presented as a provision in the statement of financial position, i.e., as a liability.[291]

For financial institutions that offer credit facilities, commitments may often be partially drawn down, i.e., an entity may have a facility that includes both a loan (a financial asset) and an undrawn commitment (a loan commitment). If the entity cannot separately identify the ECLs attributable to the drawn amount and the undrawn commitment, IFRS 7 requires an entity to present the provision for ECLs on the loan commitment together with the allowance for the financial asset. IFRS 7 states, further, that if the combined ECLs exceed the gross carrying amount of the financial asset, then the ECLs should be recognised as a provision.[292]

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[291] IFRS 9 Appendix A
[292] IFRS 7.B8E

13.3 Accumulated impairment amount for debt instruments measured at fair value through other comprehensive income

Rather than presenting ECLs on financial assets measured at fair value through other comprehensive income as an allowance, this amount is presented as the 'accumulated impairment amount' in other comprehensive income. This is because financial assets measured at fair value through other comprehensive income are measured at fair value in the statement of financial position and the accumulated impairment amount cannot reduce the carrying amount of these assets (see section 8 above for further details).[293]

14 Disclosures

14.1 Introduction

For entities applying IFRS 9, the IFRS 7 disclosure requirements for impairment are expanded significantly compared to the requirements for entities applying IAS 39. The IFRS 7 requirements are supplemented by some detailed implementation guidance.

14.2 Scope and objectives

The objective of the disclosures is to enable users to understand the effect of credit risk on the amount, timing and uncertainty of future cash flows. To achieve this objective, the disclosures should provide:[294]

▸ Information about the entity's credit risk management practices and how they relate to the recognition and measurement of ECLs, including the methods, assumptions and information used to measure those losses (see section 14.4 below)

▸ Quantitative and qualitative information that allows users of financial statements to evaluate the amounts in the financial statements arising from ECLs, including changes in the amount of those losses and the reasons for those changes (see section 14.5 below)

▸ Information about the entity's credit risk exposure, i.e., the credit risk inherent in its financial assets and commitments to extend credit, including significant credit risk concentrations (see section 14.6 below)

An entity will need to determine how much detail to disclose, how much emphasis to place on different aspects of the disclosure requirements, the appropriate level of aggregation or disaggregation, and whether additional explanations are necessary to evaluate the quantitative information disclosed.[295] If the disclosures provided are insufficient to meet the objectives above, additional information that is necessary to meet those objectives must be disclosed.[296]

To avoid duplication, IFRS 7 allows this information to be incorporated by cross-reference from the financial statements to some other statement that is available to users of the financial statements on the same terms and at the same time, such as a management commentary or risk report. Without the information incorporated by cross-reference, the financial statements are incomplete.[297]

The new IFRS 7 credit risk disclosure requirements have been expanded significantly and are supplemented by some detailed implementation guidance.

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[293] IFRS 9.4.1.2A, 5.5.2, Appendix A
[294] IFRS 7.35B
[295] IFRS 7.35D
[296] IFRS 7.35E
[297] IFRS 7.35C

A number of the disclosures in respect of credit risk are required to be given by class. In determining these classes, financial instruments in the same class should reflect shared economic characteristics with respect to credit risk. A lender, for example, might determine that residential mortgages, unsecured consumer loans and commercial loans each have different economic characteristics.[298]

14.3 EDTF recommendations on ECL disclosures for banks

The Enhanced Disclosure Task Force (EDTF) was established by the Financial Stability Board (FSB) in 2012, to seek to improve the quality, comparability and transparency of risk disclosures, by bringing together banks, investors, analysts and auditors. In 2015, the FSB asked the EDTF to consider disclosures that might be useful to help the market understand the changes as a result of the ECL approach and to promote consistency and comparability. In November 2015, the EDTF published its report, *Impact of Expected Credit Loss Approaches on Bank Risk Disclosures*, in which it recommended disclosures for banks to provide with the implementation of the ECL requirements of IFRS 9 and US GAAP.

While some of the EDTF recommended disclosures overlap with those required by IFRS 7, as amended by IFRS 9, many of the disclosures are new and not included in any other framework or authoritative guidance. Banks have to assess the availability and quality of data that are necessary to provide these disclosures and, more generally, the full range of the EDTF disclosures.

It should be noted that, while the EDTF is not a standard setter and its recommendations are not mandatory, regulators in a number of countries have strongly encouraged their implementation, and analysts, investors and other stakeholders are showing an increased interest in them. The recommendations are designed for large international banks, but they should be equally relevant for other banks that actively access the major public equity or debt markets.

Many of the recommendations relate to the period from 2015 to 2017 as the implementation date of IFRS 9 drew near. In this publication, we make reference only to the EDTF's recommendations for ongoing reporting under IFRS 9 subsequent to implementation and not to the transition discosures. The recommended disclosures of the consequent impact on regulatory capital are also outside the scope of this publication.

How we see it

Although the EDTF recommendations are targeted at large international banks, they provide a useful list of considerations for all entities for which the impact of the IFRS 9 impairment requirements is particularly material.

14.4 Credit risk management practices

IFRS 7 requires that an entity should explain its credit risk management practices and how they relate to the recognition and measurement of expected credit losses. To meet this objective, the entity should disclose information that enables users to understand and evaluate:[299]

▸ How it has determined whether the credit risk of financial instruments has increased significantly since initial recognition, including if and how:

  ▸ Financial instruments are considered to have low credit risk (see section 5.4.1), including the classes of financial instruments to which it applies

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[298] IFRS 7.IG21
[299] *IFRS 7.35F*

- ▸ The presumption that there have been significant increases in credit risk since initial recognition when financial assets are more than 30 days past due has been rebutted (see section 5.4.2)

- ▸ Its definitions of default, including the reasons for selecting those definitions (see section 4.1). This may include:[300]

  - ▸ The qualitative and quantitative factors considered in defining default

  - ▸ Whether different definitions have been applied to different types of financial instruments

  - ▸ Assumptions about the cure rate, i.e., the number of financial assets that return to a performing status, after a default has occurred on the financial asset

- ▸ How the instruments were grouped if ECLs were measured on a collective basis (see section 5.5.2)

- ▸ How it has determined that financial assets are credit-impaired (see section 3.1)

- ▸ Its write-off policy, including the indicators that there is no reasonable expectation of recovery and information about the policy for financial assets that are written-off but are still subject to enforcement activity (see section 13.1.1)

- ▸ How the requirements for the modification of contractual cash flows of financial instruments have been applied (see section 7), including how the entity:

  - ▸ Determines whether the credit risk on a financial asset that has been modified, while the loss allowance was measured at an amount equal to lifetime ECLs, has improved to the extent that the loss allowance reverts to being measured at an amount equal to 12-month ECLs

  - ▸ Monitors the extent to which the loss allowance on financial assets meeting the criteria in the previous bullet is subsequently re-measured at an amount equal to lifetime ECLs

How we see it

An asset (or portion thereof) should be written off only if there is no reasonable expectation of recovery.[301] Consequently, it is not entirely clear in which circumstances an entity would need to disclose a policy for financial assets that are written off but are still subject to enforcement activity

The standard suggests that quantitative information that will assist users in understanding the subsequent increase in credit risk of modified financial assets, may include information about modified financial assets meeting the criteria above for which the loss allowance has reverted to being measured at an amount equal to lifetime ECLs, i.e., a re-deterioration rate.[302] Including qualitative information can also be a useful way of meeting this disclosure requirement.

The EDTF recommends banks to disclose how the risk management organisation, processes and key functions have been organised to calculate

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[300] IFRS 7.B8A
[301] IFRS 9.5.4.4
[302] IFRS 7.B8B

ECLs, highlighting how credit practices and policies form the basis for ECL calculations.[303]

The EDTF highlights that, although regulatory and accounting frameworks use calculations with similar concepts, the precise definitions of these concepts will differ. Consequently, it recommends that banks clearly define all the terms used in the calculation of expected credit losses, with a focus on explaining differences between the definitions used for regulatory purposes and those for IFRS 9. For example, banks should make clear the extent to which the accounting definition of default is consistent with the definition used for internal management purposes and how it compares to the regulatory definition. A further example is the time horizon over which ECLs are measured for types of contracts where a specific interpretation is required, such as revolving facilities. The EDTF also recommends that banks should provide their definition for those terms that are not formally defined, such as 'through the cycle', 'point in time' and 'behavioural life'.[304]

Other disclosures encouraged by the EDFT for banks to consider include:[305]

▸ In addition to defining 'default', describing whether the 90-day rebuttable presumption is used and in what circumstances

▸ In describing how a significant increase in credit risk is determined, how individual assessments and portfolio assessments are applied, plus the application of any temporary collective adjustments. This description should address:

  ▸ Indicators used, such as credit risk ratings, past due status, PDs, or watch lists

  ▸ Interpretation of what is understood by a 'significant increase in credit risk', at an appropriate level of portfolio segmentation and granularity

  ▸ The types of forward-looking information used and how it is used

  ▸ For portfolio assessments, identification of specific exposures or sub-portfolios affected by a deterioration in macroeconomic conditions (the bottom up approach), or how a top down approach has been applied (see section 5.5.3)

▸ For exposures where it may be difficult to determine credit risk at initial recognition, such as current accounts, revolving facilities and renewable exposures, the approach the bank has used.

▸ The circumstances in which modifications of a loan would lead to its derecognition and the recognition of a new loan.

▸ How forbearance is treated, including when forborne exposures are transferred to stage 2 or are considered credit-impaired, and the procedures for transferring 'cured' exposures back to stage 1. Also, when there are specific regulatory pronouncements on modifications, how these are reflected in the IFRS 9 approach.

IFRS 7 requires that an entity should explain the inputs, assumptions and estimation techniques used to apply the impairment requirements of IFRS 9. For this purpose it should disclose:[306]

▸ The basis of inputs and assumptions and the estimation techniques used to:

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[303] EDTF Recommendation 5
[304] EDTF Recommendation 2
[305] EDTF Recommendation 2
[306] IFRS 7.35G

- ▸ Measure 12-month and lifetime ECLs (see sections 4.2. and 4.3)

- ▸ Determine whether the credit risk of financial instruments has increased significantly since initial recognition (see section 5)

- ▸ Determine whether a financial asset is credit-impaired (see section 3.1)

  This may include information obtained from internal historical information or rating reports and assumptions about the expected life of financial instruments and the timing of the sale of collateral.[307]

- ▸ How forward-looking information has been incorporated into the determination of ECLs, including the use of macroeconomic information. Where relevant, this will include information about the use of multiple economic scenarios in determining the expected credit losses (see section 4.6)

- ▸ Changes in estimation techniques or significant assumptions made during the reporting period and the reasons for those changes

The EDTF also recommends that banks should consider disclosing the following features of their ECL modelling techniques:[308]

- ▸ For PDs, EADs, LGDs and credit conversion factors, the types of input used, the most relevant assumptions and judgements made, and the uncertainties involved

- ▸ The types of forward looking information used to calculate ECLs and how the impact of this information on ECLs is determined. This discussion should include the extent to which judgement is required and how it is applied

- ▸ How ECL modelling builds on Basel regulatory capital models and the differences in approach, such as the use of Basel floors, downturn adjustments, time horizons and discount factors

Where the parameters are not based on those used for Basel modelling, how they were developed and the use of expert judgement, which may be of particular relevance for low-default and low-volume portfolios

- ▸ The use and nature of material additional adjustments to capture factors not specifically embedded in the models used to calculate ECLs

The EDTF further recommends that banks should describe their policies for identifying impaired or non-performing loans, including how the bank defines impaired or non-performing, restructured and returned-to-performing (cured) loans as well as explanations of loan forbearance policies.[309]

The EDTF recommends that consideration should be given to providing dislcosure of the key drivers of change in credit losses, but only where they are meaningful and relevant to understanding the material changes:[310]

- ▸ All top and emerging risks should be discussed, including their impact (or not) on ECLs, either quantitatively or qualitatively as appropriate.

- ▸ Sensitivity analyses can provide useful quantitative information when they are meaningful and relevant to understanding how credit risks can change materially. This is most likely to be the case if an individual risk parameter has a significant impact on the overall credit risk of the portfolio, because a change in any individual parameter will often be associated with correlated

> Sensitivity analysis is useful if an individial risk parameter has a significant impact on the portfolio's credit risk.

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[307] IFRS 7.B8C
[308] EDTF Recommendation 2
[309] EDTF Recommendation 27
[310] EDTF Recommendation 3

changes in other factors. Sensitivity information is also likely to be more useful for users if it is used for internal credit risk management. Examples of possible sensitivities that might be disclosed include:

- ‣ Variables that cause an impact on a loan portfolio on an ongoing basis. An example would be the sensitivity to house prices for a residential mortgage portfolio

- ‣ Changes that emerge at a particular point in time for specific portfolios. An example would be an economic shock to a specific industry

- ‣ An alternative to disclosure of the effect of varying an individual parameter would be to disclose the ECLs based on an alternative reasonably possible scenario, which would incorporate changes in several underlying parameters.

- ‣ Quantitative disclosures may be less appropriate for some risks that are relevant, but which are not easily reflected in ECL models. Examples of risks that are not easily reflected in ECL models would include economic or political developments, for which qualitative disclosures may be more appropriate. An example that has emerged since the EDTF published its report is the impact of 'Brexit'.

14.5 Quantitative and qualitative information about amounts arising from expected credit losses

14.5.1 Changes in the loss allowance and the gross exposures

An entity should explain the changes in the loss allowance and reasons for those changes by presenting a reconciliation of the opening balance to the closing balance. This should be given in a table for each relevant class of financial instruments, showing separately the changes during the period for:[311]

- ‣ The loss allowance measured at an amount equal to 12-month ECLs

- ‣ The loss allowance measured at an amount equal to lifetime ECLs for:

  - ‣ Financial instruments for which credit risk has increased significantly since initial recognition, but that are not credit-impaired financial assets

  - ‣ Financial assets that are credit-impaired at the reporting date (but were not credit-impaired when purchased or originated)

  - ‣ Trade receivables, contract assets or lease receivables for which the loss allowance is measured using a simplified approach based on lifetime ECLs

- ‣ Financial assets that were credit-impaired when purchased or originated. The total amount of undiscounted ECLs on initial recognition of any such assets during the reporting period should also be disclosed

In addition, it may be necessary to provide a narrative explanation of the changes in the loss allowance during the period. This narrative explanation may include an analysis of the reasons for changes in the loss allowance during the period, including:[312]

- ‣ The portfolio composition

- ‣ The volume of financial instruments purchased or originated

- ‣ The severity of the ECLs

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[311] IFRS 7.35H
[312] IFRS 7.B8D

These requirements, along with a number of others set out in IFRS 7 and/or recommended by the EDTF, are illustrated in Example 28.

The EDFT emphasises the importance of distinguishing between changes in ECLs that are due to movements in loan balances (including new lending, recoveries and write offs), from those due to model changes and those due to changes to credit risk parameters.

The EDTF also notes that the sequencing of movements is important when preparing an allowance reconciliation. First, if transfers between stages are considered to take place at the beginning of the period, the amount of the transfer could be based on the closing balance from the previous period, which would not include any difference in measurement as a result of the change in stage or change in assumptions. Alternatively, if transfers are considered to take place at the end of the period, the amount transferred could be based on the period end balances, which may or may not include the difference in measurement as a result of the change in stage. Similarly, if changes in measurement due to movements in risk parameters are the first in the sequence, this will give a different amount for the transfer as a result of the change in stage than if the change in stage is calculated first.[313]

We also note that there are two possible ways of presenting the effect of changes in stage in the reconciliation. One possibility is to show transfers from stage 1 to 2 based on the 12 month ECLs, which will mean that the total for each transfer line will sum to zero. The change in ECLs due to the uplift from 12-month to lifetime ECLs, and the effect of any changes in parameters, must then be shown separately. Another approach, as shown in Example 28, would be to show the transfers as a reduction of the stage 1 column based on the 12-month allowances and the increase in stage 2 column based on the lifetime allowances, so that the sum of the row will equal the overall effect on ECLs due to the transfers between stages.

An explanation should also be provided of how significant changes in the gross carrying amount of financial instruments during the period contributed to changes in the loss allowance. This information should be provided separately for each class of financial instruments for which loss allowances are analysed (see above). Examples of changes in the gross carrying amount of financial instruments that contribute to changes in the loss allowance may include:[314]

▸ Changes because of financial instruments originated or acquired during the reporting period

▸ The modification of contractual cash flows on financial assets that do not result in a derecognition of those financial assets

▸ Changes because of financial instruments that were derecognised, including those that were written-off during the reporting period

▸ Changes arising from the measurement of the loss allowance moving from 12-month expected credit losses to lifetime losses (or *vice versa*)

Although, as worded, the IFRS 7 requirement to explain movements in the gross value of loans does not require a quantitative reconciliation, the implementation guidance to the standard gives one in its illustrative example.[315] The EDTF gives a similar example[316] and we have adopted this approach in Example 28.

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[313] EDTF Recommendation 28
[314] IFRS 7.35I
[315] IFRS 7 IG20B
[316] EDTF Recommendation 28

The EDTF also advocates a reconciliation of non-performing or impaired loans in the period and the associated allowance for loan losses. Disclosures should include an explanation of the effects of loan acquisitions on ratio trends, and qualitative and quantitative information about restructured loans.

The following example shows, for a fictitious bank, what some of the IFRS 7 disclosures for one class of lending might look like.

Example 28: Certain disclosures of impairment allowances by a bank for one class of lending

Small business lending

The table below shows the credit quality and the maximum exposure to credit risk based on the Bank's internal credit rating system and year-end stage classification. Except for POCI loans, the amounts presented are gross of impairment allowances. The table analyses separately those loans which are assessed and measured individually and those which are assessed and measured on a collective basis:

In $ million	2018							2017
Internal rating grade	Stage 1 Individual	Stage 1 Collective	Stage 2 Individual	Stage 2 Collective	Stage 3	POCI	Total	Total
Performing								
High grade	1,168	832	-	-	-	-	2,000	2,358
Standard grade	728	340	299	358	-	-	1,725	1,886
Sub-standard grade	-	-	213	321	-	23	557	180
Low grade	-	-	75	194	-	-	269	120
Non-performing								
Individually impaired	-	-	-	-	205	31	236	208
Total	**1,896**	**1,172**	**587**	**873**	**205**	**54**	**4,787**	**4,752**

The following is a reconciliation of the gross carrying amounts at the beginning and end of the year:

In $ million	Stage 1 Individual	Stage 1 Collective	Stage 2 Individual	Stage 2 Collective	Stage 3	POCI	Total
Gross carrying amount as at 1 January 2018	1,871	1,129	626	938	188	-	4,752
New assets originated or purchased	167	163	-	-	-	56	386
Assets derecognised or repaid (excluding write offs)	(137)	(125)	(59)	(81)	(35)	(4)	(341)
Transfers to Stage 1	16	8	(16)	(8)		-	-

Transfers to Stage 2	(48)	(19)	62	19	(14)	-	-
Transfers to Stage 3	(5)	(4)	(36)	(12)	57	-	-
Changes to contractual cash flows due to modifications not resulting in derecognition	-	-	-	-	(9)	-	(9)
Change in interest charged but not received	21	12	4	13	27		279
Amounts written off	-	-		-	(12)	-	(12)
Foreign exchange revaluation	11	8	6	4	3	-	32
At 31 December 2018	**1,896**	**1,172**	**587**	**873**	**205**	**54**	**4,787**

The following is a reconciliation of the ECL allowances as at the beginning and end of the year. The effect on ECLs of transfers between stages has been calculated based on the allowances recorded at the date of transfer:

In $ million	Stage 1 Individual	Stage 1 Collective	Stage 2 Individual	Stage 2 Collective	Stage 3	POCI	Total
ECL allowances as at 1 January 2018	48	41	36	47	79	-	251
New assets originated or purchased	5	15	-	-	-	-	20
Assets derecognised or repaid (excluding write offs)	(4)	(12)	(5)	(3)	(4)	-	(28)
Transfers to Stage 1	1	-	(2)	(1)	-	-	(2)
Transfers to Stage 2	(4)	(1)	21	5	-	-	21
Transfers to Stage 3	(1)	(1)	(10)	(4)	20	-	4
Unwind of discount	9	10	5	6	13	-	43
Changes to contractual cash flows due to modifications not resulting in derecognition	-	-	-	-	(6)	-	(6)

Example 28: Certain disclosures of impairment allowances by a bank for one class of lending (cont'd)						
Changes to models and inputs used for ECL calculations	7	10	6	5	18	3	49
Amounts written off	-	-	-	-	(12)	-	(12)
Foreign exchange revaluation	2	2	1	1	1	-	7
At 31 December 2018	**63**	**64**	**52**	**56**	**109**	**3**	**347**

Of the $587m of loans classified as stage 2 on an individual basis, $ 37m (1 January: $33m) of loans and $17m (1 January: $16m) of ECLs are more than 30 days past due.

The credit risk for the bank's small business customers is mostly affected by factors specific to individual borrowers, but, given the available information, the ECLs for the majority of the loans are measured on a collective basis. The key inputs in the ECL model, apart from the bank's own credit risk appraisal process, are assumptions about changes in Gross Domestic Product (GDP) and future interest rates. As at 1 January 2018, the base scenario assumed that GDP will increase by 2.6% in 2018 and 2.0% in 2019, with the rate of increase declining over the next four years to 1.5%. GDP grew during 2018 by only 2.0% and is now forecast to grow by only 1.3% in 2019, increasing to 1.5% over the next four years. The base rate of interest assumed in the base scenario as at 1 January 2018 was 1.2% for 2018 and 1.4% for 2109, increasing to 2.2% over the next four years. The average rate for 2018 was 1.4% and the forecast for 2019 is now 1.5%, increasing to 2.3% over the next four years.

The allowance was calculated using, in addition to the base scenario, an upside scenario and two downside scenarios, all weighted to reflect their likelihood of occurrence. The allowance as at 31 December 2018, based upon the bank's base case scenario, is $312.5m. The effect of applying multiple economic scenarios is to increase the allowance by £34.5m (11%). (As at 1 January the equivalents were: $230m, $40m and 14.8%).

Based upon past experience, reducing the growth in GDP over the next three years by 1% (keeping interest rates constant) would increase the ECLs by approximately $14m (1 January: $18m).

The largest contribution to the increase in ECLs of the portfolio during the year was the update to inputs to models to reflect the deterioration in economic conditions. However, the result of changes in the base scenario has been partly offset by a small reduction in the effect of using multiple economic scenarios.

In preparing Example 28 we have made a number of choices:

1. IFRS 7R.35I does not explicitly require a reconciliation of movements in the gross carrying amounts in a tabular format and the standard's requirement could be addressed using a narrative explanation. However, the example in the Illustrative Guidance (IFRS 7R.IG20B) provides a reconciliation in a tabular format and the EDTF does too.

2. Small business lending was chosen for the example as it is possible that some are assessed on a specific basis and some collectively. IFRS 7 does not specifically require these to be shown separately, but two examples in the standard (IFRS7R.IG20A and B) do so.

3. The disclosure of the proportion of stage 2 loans that are 30 days past due is not required by IFRS 7, but is regarded by users as useful information.

4. We have chosen to provide only the net effect of using multiple scenarios, rather than providing details of the scenarios and their weightings, in order to avoid excessive detail.

5. Consistent with the EDTF recommendations (and aware that the various parameters are not independent), we have only disclosed sensitivity to one parameter.

The following example in the standard's Implementation Guidance illustrates how ECL information might be presented for trade receivables.[317]

Example 29: *Information about credit risk exposures using a provision matrix*

The reporting entity manufactures cars and provides financing to both dealers and end customers. It discloses its dealer financing and customer financing as separate classes of financial instruments and applies the simplified approach to its trade receivables so that the loss allowance is always measured at an amount equal to lifetime expected credit losses. The following table illustrates the use of a provision matrix as a risk profile disclosure under the simplified approach:

20XX — Trade receivables days past due

CU'000

	Current	More than 30 days	More than 60 days	More than 90 days	Total
Dealer financing					
Expected credit loss rate	0.10%	2%	5%	13%	
Estimated total gross carrying amount at default	20,777	1,416	673	235	23,101
Expected credit losses	21	28	34	31	114
Customer financing					
Expected credit loss rate	0.20%	3%	8%	15%	
Estimated total gross carrying amount at default	19,222	2,010	301	154	21,687
Expected credit losses	38	60	24	23	145

IFRS 7 also requires the disclosure of the contractual amount outstanding on financial assets that were written off during the reporting period and which are still subject to enforcement activity.[318]

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[317] IFRS 7.IG20C, 20D
[318] IFRS 7.35L

14.5.2 Modifications

Information should be disclosed to provide an understanding of the nature and effect of modifications of contractual cash flows on financial assets that have not resulted in derecognition as well as the effect of such modifications on the measurement of expected credit losses. The following information should therefore be given:[319]

‣ The amortised cost before the modification and the net modification gain or loss recognised for financial assets for which the contractual cash flows have been modified during the reporting period while they had a loss allowance based on lifetime ECLs

‣ The gross carrying amount at the end of the reporting period of financial assets that have been modified since initial recognition at a time when the loss allowance was based on lifetime ECLs and, for which, the loss allowance has changed during the reporting period to an amount equal to 12-month ECLs

The discussion at the ITG on 22 April 2015 highlighted that these requirements apply to all modifications, whether they are credit-related or are due to other commercial reasons. However, if an entity has the ability to separately identify different types of modifications and considers that the separate disclosure of these items is relevant to achieving the overall objective of the disclosures in this section, the entity could provide this additional detail as part of the disclosure.

Where the loss allowance for trade receivables or lease receivables is measured using a simplified approach based on lifetime ECLs, the information about modifications need be given only if those financial assets are modified while more than 30 days past due.[320]

14.5 3. Collateral and other credit enhancements

To provide an understanding of the effect of collateral and other credit enhancements on the amounts arising from expected credit losses, the following must be disclosed by class of financial instrument:[321]

‣ The amount that best represents the maximum exposure to credit risk at the end of the reporting period without taking account of any collateral held or other credit enhancements (e.g., netting agreements that do not qualify for offset in accordance with IAS 32)

‣ A narrative description of collateral held as security and other credit enhancements, including:

    ‣ A description of the nature and quality of the collateral held

    ‣ An explanation of any significant changes in the quality of that collateral or credit enhancements as a result of deterioration or changes in the entity's collateral policies during the reporting period

    ‣ Information about financial instruments for which a loss allowance has not been recognised because of the collateral

   This might include information about:[322]

    ‣ The main types of collateral held as security and other credit enhancements, examples of the latter being guarantees, credit

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[319] IFRS 7.35J
[320] IFRS 7.35A(a)
[321] IFRS 7.35K
[322] IFRS 7.B8G

> > derivatives and netting agreements that do not qualify for offset in accordance with IAS 32

> - ‣ The volume of collateral held and other credit enhancements and their significance in terms of the loss allowance

> - ‣ The policies and processes for valuing and managing collateral and other credit enhancements

> - ‣ The main types of counterparties to collateral and other credit enhancements and their creditworthiness

> - ‣ Information about risk concentrations within the collateral and other credit enhancements

- ‣ Quantitative information about the collateral held as security and other credit enhancements, e.g., quantification of the extent to which collateral and other credit enhancements mitigate credit risk on financial assets that are credit-impaired at the reporting date

Disclosure of information about the fair value of collateral and other credit enhancements is not required by the standard, nor is a quantification of the exact value of the collateral included in the calculation of ECLs (i.e., the LGD).[323] Further, these requirements do not apply to lease receivables.[324]

14.6 Credit risk exposure

Users should be able to assess an entity's credit risk exposure and understand its significant credit risk concentrations. Therefore, an entity should disclose, by 'credit risk rating grades' (see below), the gross carrying amount of financial assets and the exposure to credit risk on loan commitments and financial guarantee contracts. This information should be provided separately for financial instruments (see Example 28):[325]

- ‣ For which the loss allowance is measured at an amount equal to 12-month ECLs

- ‣ For which the loss allowance is measured at an amount equal to lifetime ECLs and that are:

  - ‣ Financial instruments for which credit risk has increased significantly since initial recognition but are not credit-impaired financial assets

  - ‣ Financial assets that are credit-impaired at the reporting date (but were not credit-impaired when purchased or originated)

  - ‣ Trade receivables, contract assets or lease receivables for which the loss allowances are measured using a simplified approach based on lifetime ECLs. Information for these assets may be based on a provision matrix[326]

- ‣ That are financial assets that were credit-impaired when purchased or originated

The guidance to IFRS 7 explains that the number of credit risk rating grades used to disclose the information above should be consistent with the number that the entity reports to key management personnel for credit risk management purposes. If past due information is the only borrower-specific information available and so, using the operational simplification discussed at

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[323] IFRS 7.B8F
[324] IFRS 7.35A(b)
[325] IFRS 7.35M
[326] IFRS 7.35N

5.4.2, it is used to assess whether credit risk has increased significantly since initial recognition, an analysis by past due status should be provided for that class of financial assets.[327]

The standard adds that, when ECLs are measured on a collective basis, it may not be possible to allocate the gross carrying amount of individual financial assets or the exposure to credit risk on loan commitments and financial guarantee contracts to the credit risk rating grades for which lifetime ECLs are recognised. In that case, the disclosure requirement above should be applied to those financial instruments that can be directly allocated to a credit risk rating grade and separate disclosure should be given of the gross carrying amount of financial instruments for which lifetime ECLs have been measured on a collective basis.[328]

IFRS 7 also requires similar disclosure for concentrations of credit risk.[329] A concentration of credit risk exists when a number of counterparties are located in a geographical region or are engaged in similar activities and have similar economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions. Information should be provided to enable users to understand whether there are groups or portfolios of financial instruments with particular features that could affect a large portion of that group of financial instruments, such as concentration to particular risks. This could include, for example, loan-to-value groupings, geographical, industry or issuer-type concentrations.[330]

EDTF also advises banks to provide a vintage analysis, where it aids understanding of the credit risk exposures, particularly when there is a lending portfolio with heightened credit risk, and the period in which it was originated has a bearing on the extent of that credit risk and the resulting ECLs.[331]

14.7 Collateral and other credit enhancements obtained during the period

When an entity obtains financial or non-financial assets during the period by taking possession of collateral it holds as security, or calling on other credit enhancements such as guarantees, and these assets meet the recognition criteria in other standards, it should disclose for such assets held at the reporting date:[332]

‣ The nature and carrying amount of the assets

‣ When the assets are not readily convertible into cash, the entity's policies for disposing of such assets or for using them in its operations

This disclosure is intended to provide information about the frequency of such activities and the entity's ability to obtain and realise the value of the collateral.[333]

How we see it

The disclosures required by IFRS 7 in respect of ECLs are substantial. It is critical for entities to align their credit risk practices and financial reporting systems and processes, not only to estimate the loss allowances for ECLs, but also to produce sufficiently detailed information to meet the disclosure requirements.

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[327] IFRS 7.B8I
[328] IFRS 7.B8J]
[329] *IFRS 7.35M*
[330] IFRS 7.B8H
[331] Recommendation 26
[332] IFRS 7.38
[333] IFRS 7.BC56.

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