

Snapshot: Financial Instruments: Expected Credit Losses

This Snapshot introduces the revised Exposure Draft *Financial Instruments: Expected Credit Losses*.

It provides an overview of the main proposals that were developed by the IASB.

Project objective:	The objective of these proposals is to provide users of financial statements with more useful information about an entity's expected credit losses on its financial assets and commitments to extend credit.
Project stage:	The IASB is inviting comment on its revised proposals for a new Standard on the accounting for expected credit losses. Once these proposals are finalised, they will be added as a chapter to IFRS 9 <i>Financial Instruments</i> .
Comment deadline:	5 July 2013.
Next steps:	<p>The IASB will undertake outreach activities during the comment period to obtain additional feedback that will be considered when it finalises the Standard. The IASB's outreach activities will include an analysis of the effects of the proposals.</p> <p>This exposure draft builds on feedback received on the IASB's previous exposure documents. Following redeliberations on this additional consultation, the IASB expects to have received enough information to proceed to finalise its impairment project. This will complete the second phase of the project to replace IAS 39 <i>Financial Instruments: Recognition and Measurement</i>.</p>

Background

Why is the IASB addressing impairment?

During the financial crisis, the delayed recognition of credit losses on loans (and other financial instruments) was identified as a weakness in existing accounting standards. Specifically, because the existing model (an ‘incurred loss’ model) delays the recognition of credit losses until there is evidence of a credit loss event, the Financial Crisis Advisory Group (FCAG)¹ recommended exploring alternatives to the incurred loss model that would use more forward-looking information.

The complexity of the current accounting which uses many different impairment models for financial instruments within the scope of this Exposure Draft was also identified as a concern.

How would these proposals improve financial reporting?

The main objective in developing these proposals is to provide users of financial statements with more useful information about an entity’s expected credit losses on its financial assets and its commitments to extend credit.

The proposals would eliminate the threshold to the recognition of expected credit losses so that it would no longer be necessary for a credit event to have occurred before credit losses are recognised. Instead, expected credit losses, and changes in those expectations of credit losses, would always be recognised. The amount of expected credit losses would be updated at each reporting date to reflect changes in credit quality. Consequently, more timely information would be provided about expected credit losses.

Furthermore, when credit losses are currently measured in accordance with IFRS, an entity may only consider those losses that arise from past events and current conditions. The effects of future credit loss events cannot be considered, even when they are expected. The proposals in this Exposure Draft would broaden the information that an entity is required to consider when determining its expectations of credit losses.

Specifically, the proposals in this Exposure Draft would require an entity to base its measurement of expected credit losses on relevant information about past events, including historical credit loss events for similar financial instruments, current conditions and reasonable and supportable forecasts.

In addition, the same model would be applied to all financial instruments that are subject to impairment accounting removing a major source of current complexity.

¹ The FCAG was an advisory group of senior figures that was set up by the IASB and the FASB as part of a joint approach to dealing with the financial reporting issues arising from the financial crisis. The report of the FCAG is available to download from www.ifrs.org

Who would be affected by the proposals?

All entities that hold financial assets or commitments to extend credit that are not accounted for at fair value through profit or loss would be affected by these proposals. This includes financial assets measured at amortised cost or that are mandatorily measured at fair value through other comprehensive income (FVOCI)², trade receivables and lease receivables, loan commitments and financial guarantee contracts.

Is this a joint project?

Consistent with requests from the G20, the FCAG and others, the IASB and the US Financial Accounting Standards Board (FASB) have been working jointly to develop a more forward-looking impairment model that reflects expected credit losses.

The FASB have published separate proposals for an expected credit loss model (the Current Expected Credit Loss or ‘CECL’ model. See FASB Proposed Accounting Standards Update *Financial Instruments—Credit Losses*). The IASB and the FASB jointly deliberated some aspects of their individual proposals, however the boards have found it difficult to achieve a converged solution because of jurisdictional differences in regulatory and systems environments.

The two sets of proposals have overlapping comment periods, enabling interested parties to comment on both proposals.

² In accordance with the proposals in ED 2012/4 *Classification and Measurement: Limited Amendments to IFRS 9*.

Overview of the proposed impairment model

The IASB proposes that expected credit losses would be recognised for all financial instruments subject to impairment accounting.

What are expected credit losses?

Expected credit losses are an estimate of losses that an entity expects will result from a credit event, such as a payment default. Expected credit losses are a cost of lending activity.

What is the economic effect of expected credit losses?

These costs are reflected through:

- (a) the pricing (yield) of financial instruments, which compensates the lender for the creditworthiness of the borrower at the time of lending or committing to lend; and
- (b) changes in the creditworthiness of the borrower after lending or committing to lend (ie changes in expected credit losses). These changes in expected credit losses are not priced into the financial instruments, so give rise to an economic loss.

How would expected credit losses be reflected?

Expected credit losses would be recognised from the point at which financial instruments are originated or purchased. There would no longer be a threshold before expected credit losses would start to be recognised.

The amount of expected credit losses that are recognised would depend on the change in credit quality since initial recognition to reflect the link between expected credit losses and the pricing of the financial instrument.

A broad range of interested parties, including users of financial statements, have said that a distinction should be made between assets that have deteriorated in credit quality and those that have not.

The proposed model would build on existing systems and information that many entities already use for credit risk management purposes.

How would this compare with the incurred loss model in IAS 39?

When applying the existing incurred loss model in practice, it is often the case that the recognition of an allowance for expected credit losses is delayed until a default has already occurred on a financial instrument. This would be the case even when credit losses are expected and was identified during the financial crisis as a weakness in accounting standards.

The proposals in the Exposure Draft result in lifetime expected credit losses being recognised when the credit quality of a financial instrument is worse than that anticipated when the financial instrument was first originated or purchased. This enables economic credit losses to be better reflected in the financial statements.

Consistent with the recommendations by the G20 Leaders, the FCAG and others, the proposed expected credit losses model would be more forward-looking and consider a broader range of information than the existing incurred loss model.

Why recognise expected credit losses from initial recognition?

A portion of lifetime expected credit losses is recognised from when financial instruments are first originated or purchased.¹ This is a way to reflect that the yield on the instrument includes a return to cover those credit losses expected from when a financial instrument is first recognised.

If this amount was not recognised the full yield would be recognised as interest revenue with no adjustment for credit losses that were always expected.

¹ If a financial instrument is credit-impaired when first recognised the full lifetime expected credit losses at that time are recognised by adjusting the interest rate used to calculate interest revenue.

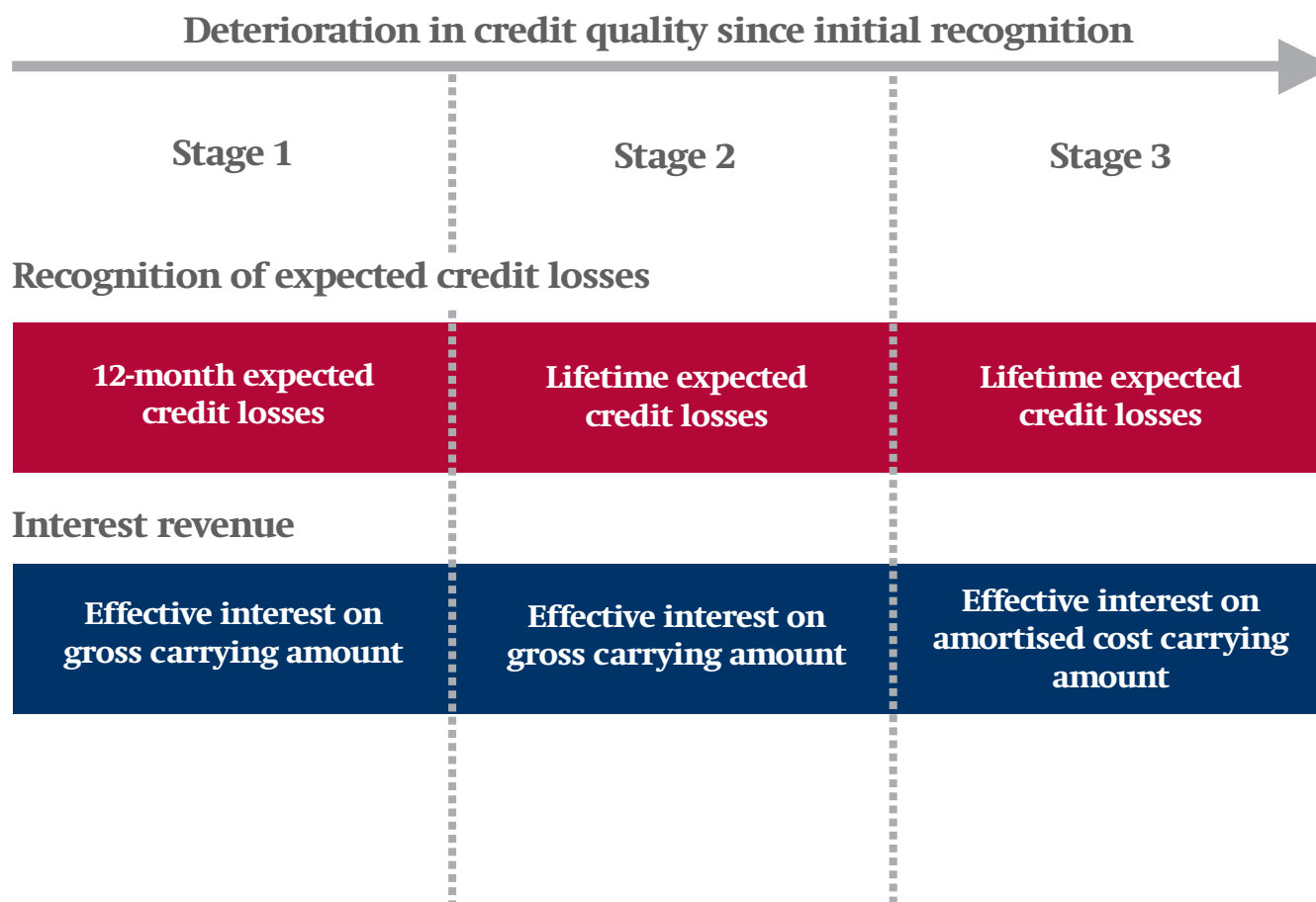
Overview of the proposed model

What are 12-month expected credit losses?

An entity calculates '12-month expected credit losses' by multiplying the probability of a default occurring in the next 12 months by the total (lifetime) expected credit losses that would result from that default.

They are not the expected cash shortfalls over the next twelve months—instead, it is the effect of the entire credit loss on a financial instrument weighted by the probability that this loss will occur in the next 12 months.

They are also not the credit losses on financial instruments that are forecast to actually default in the next 12 months. If an entity can identify such financial instruments individually or as a portfolio the credit quality is expected to have deteriorated significantly (so lifetime expected credit losses are recognised) or to have been credit-impaired on initial recognition.



What are the stages?

Stage 1

As soon as a financial instrument is originated or purchased 12-month expected credit losses would be recognised in profit and loss and an allowance for expected credit losses (loss allowance) or provision would be established.

This would serve as a proxy for the initial expectations of credit losses that are priced into the financial instrument.

For financial assets, interest revenue would be calculated on the gross carrying amount of the financial asset (ie without adjustment for the loss allowance).

Stage 2

When the credit risk increases (or credit quality deteriorates) significantly **and** the resulting credit quality is below “investment grade”. Full lifetime expected credit losses would be recognised.

Lifetime expected credit losses would only be recognised if the credit quality deteriorates significantly from that at origination or purchase.

The calculation of interest revenue on financial assets remains unchanged.

Stage 3

When the credit quality of a financial asset deteriorates to the point that credit losses are incurred or the asset is credit-impaired. Interest revenue is then calculated based on the net amortised cost carrying amount (ie the gross carrying amount adjusted for the loss allowance).

The recognition of expected credit losses is unchanged. Lifetime expected credit losses are still recognised.

What are lifetime expected credit losses?

Lifetime expected credit losses are an expected present value measure of credit losses that arise if a borrower defaults on their obligation throughout the life of a financial instrument. They are the weighted average credit losses with the respective probabilities of default as the weights.

The 12-month expected credit losses are the portion of the lifetime expected credit losses associated with the possibility of a default in the next twelve months.

Because the measure of credit losses is a present value, a credit loss may result from a delay in the payment of contractually required amounts, even if those amounts are expected to be paid in full.

Accounting for expected credit losses—the 2009 ED

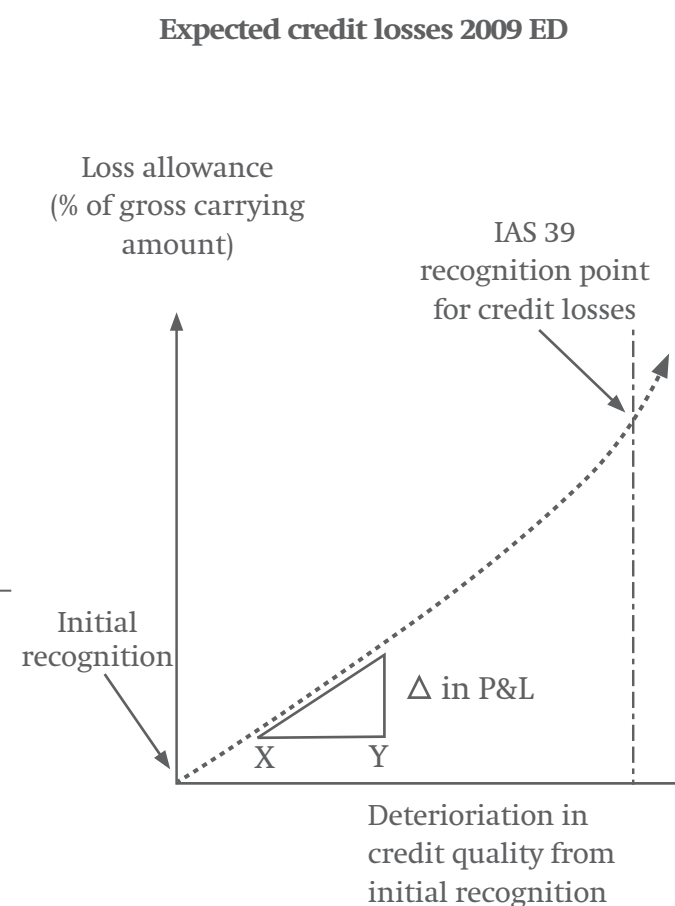
The existing incurred loss model in IAS 39 results in credit losses being recognised only when a credit loss event occurs. Changes in the creditworthiness of borrowers are not recognised until such a credit loss event occurs (typically when a payment default actually occurs).

However, the change in the creditworthiness of borrowers results in an economic loss.

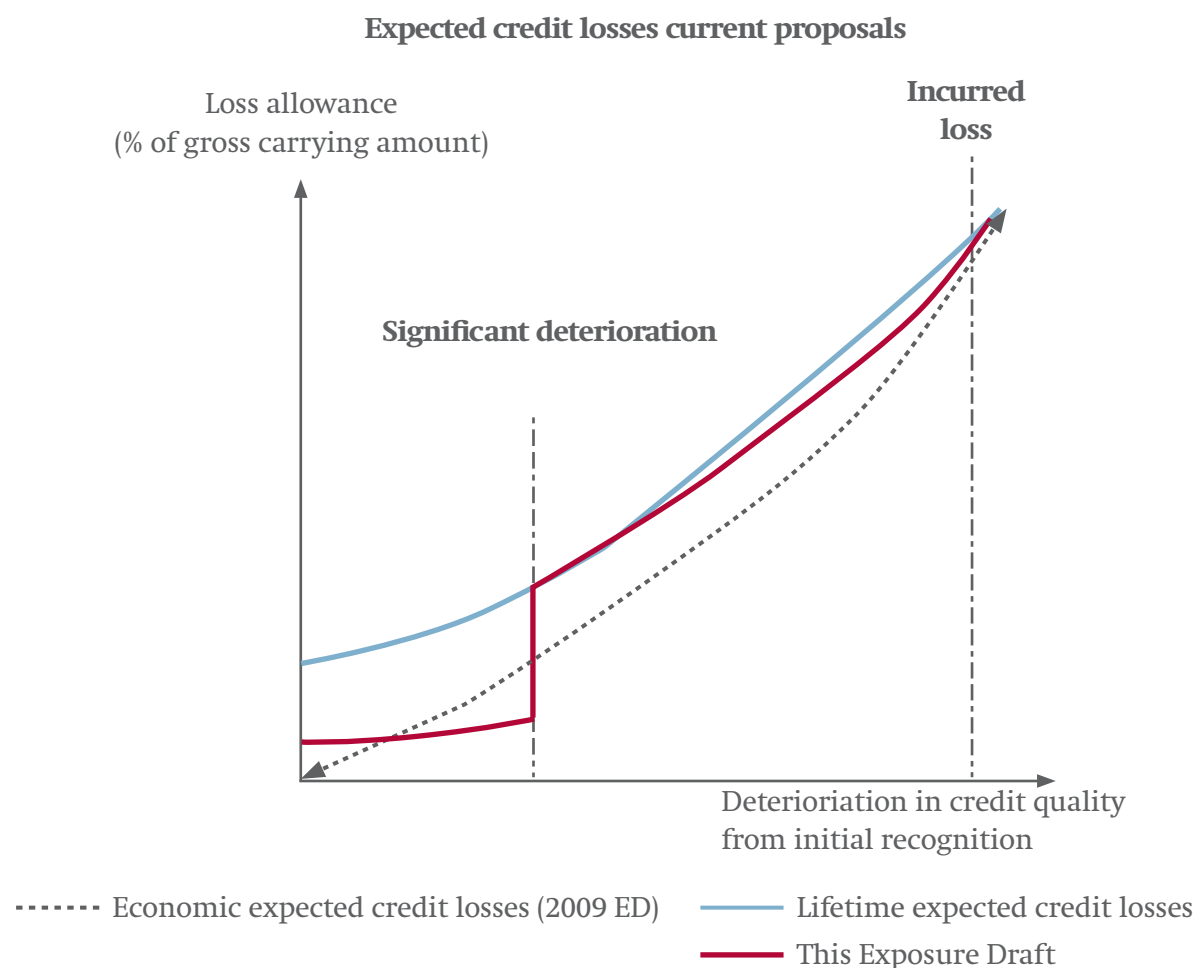
This economic loss was represented by the expected cash flow model in the Exposure Draft ED/2009/12 *Financial Instruments: Amortised Cost and Impairment* (the 2009 ED). The expected credit losses arising as a result of credit deterioration as per this model are represented by the dashed line on the graph to the right.

As illustrated, the model would have a loss allowance of nil at initial recognition, and the loss allowance would increase as creditworthiness deteriorates. This would not occur smoothly – for example, if the credit quality at the previous reporting date was X and at the following reporting date was Y, then the change in credit loss expectations reflected by the move from X to Y would be recognised in profit or loss in that period.

However, following an analysis of the effects of those proposals, the IASB concluded that the model in the 2009 ED presented many operational challenges and that the benefits would not outweigh the costs of overcoming those challenges.



Accounting for expected credit losses—as proposed



In this Exposure Draft the IASB has sought to approximate the outcome of the 2009 ED in a more operational manner.

To do this, this Exposure Draft proposes that an entity recognise 12-month expected credit losses from initial recognition, until there has been a *significant deterioration in credit quality* (or increase in credit risk), at which point the *lifetime expected credit losses are recognised*. This results in a stepped profile as illustrated.

Recognising a portion of the lifetime expected credit losses, and then the full lifetime expected credit losses only after a significant deterioration in credit quality:

- (a) ensures a more timely recognition of expected credit losses than the existing incurred loss model;
- (b) distinguishes between financial instruments that have significantly deteriorated in credit quality and those that have not; and
- (c) better approximates the economic expected credit losses.

Recognition of lifetime expected credit losses

When would an entity recognise lifetime expected credit losses?

This Exposure Draft proposes that an entity recognises lifetime expected credit losses when credit risk increases significantly compared to the credit risk at initial recognition.

However, to simplify the application of the model, the Exposure Draft proposes that:

- (a) an entity does not recognise lifetime expected credit losses for financial instruments that are equivalent to *investment grade*;
- (b) there is a rebuttable presumption that lifetime expected credit losses should be recognised if *payments are more than 30 days past due*; and
- (c) for trade receivables and lease receivables, an entity can choose to always recognise lifetime expected credit losses.

What should be considered when assessing changes in credit risk?

An entity should consider the best available information when assessing the change in credit risk, including reasonable and supportable forecast information. An entity need not make an exhaustive search for information. Only information that is available without undue cost or effort is required to be used. The Exposure Draft includes application guidance that lists factors that might be considered when assessing credit quality.

How should an entity assess if there has been a significant increase in credit risk?

The proposals require the risk of a default to be assessed. So, an entity should consider the change in the probability of a default occurring on a financial instrument rather than assessing whether there is a change in the amount of expected credit losses that would arise if a default occurred.

Is the assessment of a significant increase in credit risk subjective?

An entity's estimate of expected credit losses and credit risk are inherently subjective.

Market-based measures of credit risk, such as credit spreads, are important indicators of changes in credit risk and should not be ignored.

Entities need to decide what information is most relevant and persuasive in their assessment of credit risk.

This Exposure Draft proposes that an entity discloses the methods, inputs and assumptions that are used when assessing when lifetime expected credit losses are recognised and in measuring expected credit losses.

By requiring lifetime expected credit losses to be recognised when the change in credit risk on a financial instrument is significant it is expected that entities should be able to use information they have available for credit risk management purposes as a basis for applying the proposals.

Why recognise lifetime expected credit losses only after a significant increase in credit risk?

As noted previously, the initial creditworthiness of the borrower, and the initial expectations of credit losses, are included in the pricing of a financial instrument.

A true economic loss arises when expected credit losses significantly exceed initial expectations ie when the lender is receiving inadequate compensation for the level of credit risk to which it is now exposed. By recognising lifetime expected credit losses following a significant increase in credit risk that economic loss is reflected in the financial statements.

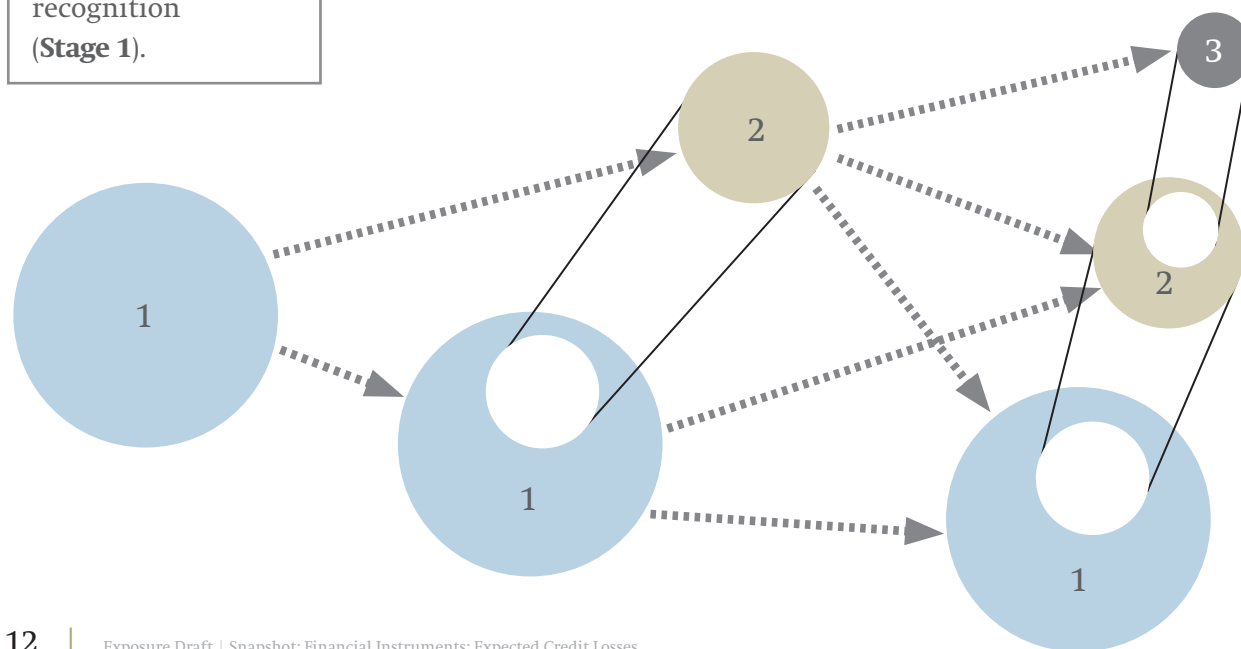
Accounting for expected credit losses—example

Portfolio of home loans originated in a country.
12-month expected credit losses are recognised for all the loans on initial recognition (**Stage 1**).

Information emerges that a region in the country is experiencing tough economic conditions.
Lifetime expected credit losses are recognised for those loans within that region (**Stage 2**) and 12-month expected credit losses, including any changes in that estimate, for other loans (**Stage 1**).

More information emerges and the entity is able to identify the particular loans that have defaulted or will imminently default (**Stage 3**). Lifetime expected credit losses continue to be recognised and interest revenue switches to a net interest basis.

Ultimately, the subset of loans in Stage 2 either will end up defaulted (in Stage 3) or will continue to perform (potentially returning to Stage 1)



- Stage 1
- Stage 2
- Stage 3

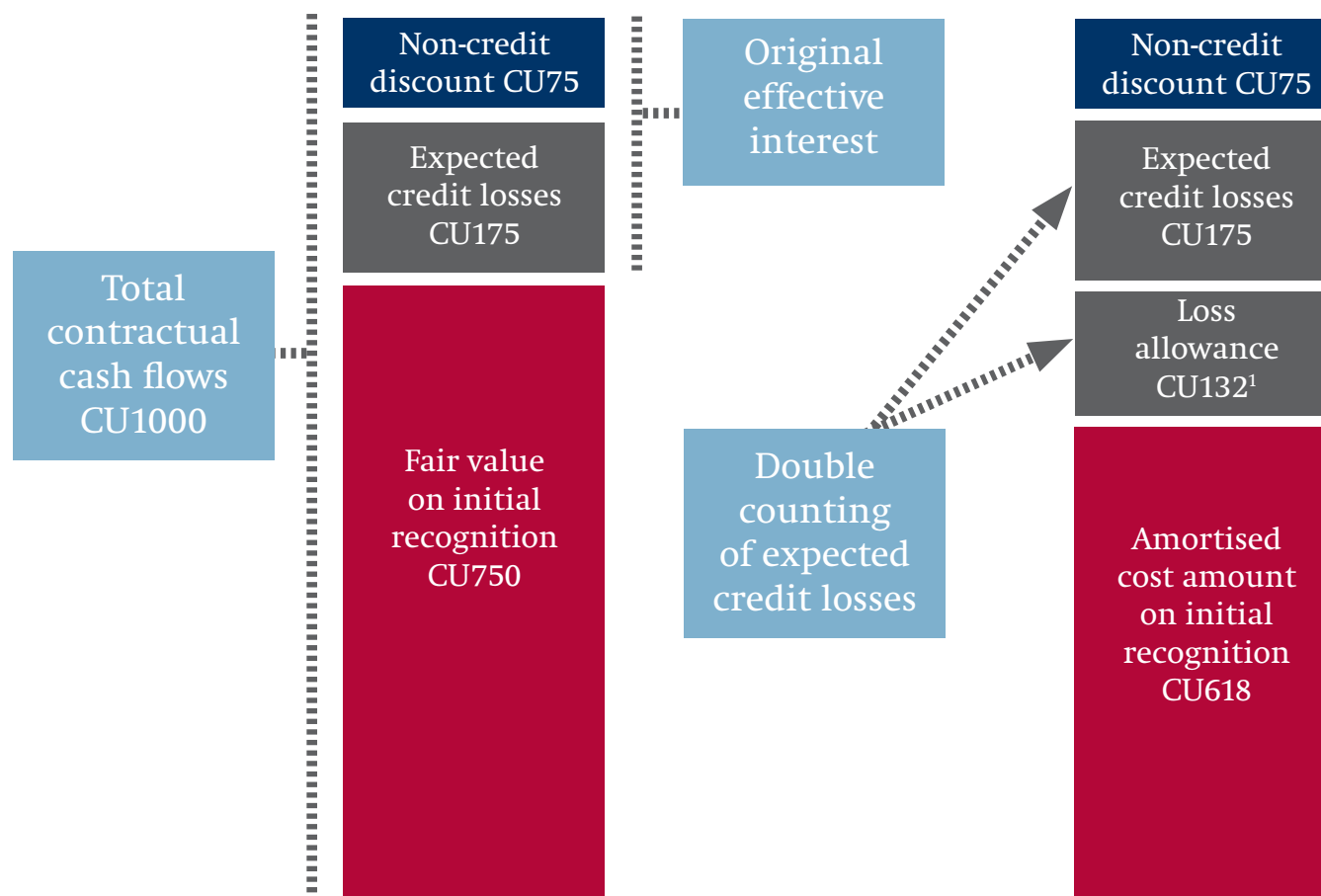
Why not always recognise lifetime expected credit losses?

Recognising lifetime expected credit losses from initial recognition disregards the economic link between pricing and the initial expectations of credit losses.

Recognising lifetime expected credit losses on *all* financial instruments does not faithfully represent the economic expected credit losses. Furthermore, it results in:

- (a) the double-counting of expected credit losses that are priced into a financial asset. The margin on an asset is sufficient to cover the initial expected credit losses.
- (b) a loss of information about the changes in credit quality—meaning that it is not apparent whether losses recognised represent an economic loss, or will be compensated by future interest revenue.

This results in financial instruments having a carrying amount that is below their fair value or transaction price on initial recognition (as in the diagram where a loan with a value of CU750 is on the balance sheet at CU618).



¹ Expected credit losses of 175 discounted at the original effective interest rate

Convergence between IFRS and US GAAP

Both IFRS and US GAAP currently use an incurred loss impairment model. This model also includes an initial recognition threshold. Similarly, when credit losses are measured in accordance with US GAAP, an entity generally only considers past events and current conditions.

The boards have been working to develop a more forward-looking impairment model that is based on expected credit losses.

In response to requests to reach a common solution, the boards published the supplement *Financial Instruments: Impairment* to their individual original exposure documents (the SD). The SD attempted to incorporate the original objectives of both boards.

After issuing the SD, the boards worked together to jointly develop an expected credit loss model that formed the initial basis for the proposals in this Exposure Draft.

Why has the FASB proposed a different model?

In July 2012 the FASB decided to revisit its previous tentative decisions on that joint model and to develop a different expected credit loss model (the CECL model). In the CECL model, a distinction is not made between those financial instruments that have deteriorated since initial recognition and those that have not. Instead expected credit losses are always recognised at what the IASB describes in its proposals as lifetime expected credit losses. This means that an entity would not measure the loss allowance for any financial instruments using 12-month expected credit losses.

Are there common features?

There are common features between the two proposed models. Both proposed models remove any threshold for the recognition of expected credit losses. In addition, the information that is used to estimate and measure expected credit losses is consistent for the two models. Also, for assets that have deteriorated significantly in credit quality since initial recognition and that are not “investment grade”, the amount of expected credit losses that is recognised under the two proposed models should be the same.

Further information

This Exposure Draft includes questions on the proposals. Respondents are invited to comment on any or all of those questions and to comment on any other issue that the IASB should consider when finalising the proposals. The IASB's redeliberations of the proposals will take place in public meetings. Information about these public meetings will be available from the IASB's website.

The deadline for comments on the exposure draft is 5 July 2013. To view the Exposure Draft and to submit your comments, visit <http://go.ifrs.org/Financial-Instruments-Impairment>.

Previous exposure documents and the comment letters on those documents, including the 2009 ED and the SD, are also available on the project homepage.

To stay up to date with the latest developments of the project to replace IAS 39 and to sign up for email alerts about this project, please visit the project homepage on www.ifrs.org.

International Accounting Standards Board (IASB)

30 Cannon Street | London EC4M 6XH | United Kingdom

Telephone: +44 (0)20 7246 6410 | Fax: +44 (0)20 7246 6411

Email: info@ifrs.org | Web: www.ifrs.org

For further information about the IFRS Foundation, IASB, copies of International Financial Reporting Standards, International Accounting Standards, exposure drafts and other publications, including details of IASB subscription services, please contact our Publications Department on telephone: +44 (0)20 7332 2730 or email: publications@ifrs.org

© 2013 IFRS Foundation; may be distributed freely with appropriate attribution



Printed on 100 per cent recycled paper