International Financial Reporting Standards

Exposure Draft

Expected Credit Losses

The views expressed in this presentation are those of the presenter,
not necessarily those of the IASB or IFRS Foundation

The basis for the proposals

- The yield on financial instruments reflects initial credit loss expectations
- When expected credit losses exceed those initially expected an economic loss is suffered
- This was best reflected in the 2009 ED
- Proposals reflects this in a more cost effective way by:

  – Recognising a **portion of expected credit losses initially**

  – Recognising **lifetime expected credit losses when significant deterioration in credit risk occurs**

What does it apply to?

- Debt instruments measured at amortised cost
- Debt instruments mandatorily measured at fair value through other comprehensive income (FVOCI)
- Trade receivables and lease receivables
- Other financial instruments subject to credit risk, such as:
  - some loan commitments
  - some financial guarantee contracts

Expected credit losses will be recognised for *all* of these financial instruments at *all* times.

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Overview of general model

Change in credit quality since initial recognition

Expected credit losses recognised	12-month expected credit losses	Lifetime expected credit losses	Lifetime expected credit losses
Interest revenue	Gross basis	Gross basis	Net basis
	Stage 1	Stage 2	Stage 3

What are the three stages?

- Stage 1
  - No significant deterioration in credit quality; or
  - ‘Investment grade’
- Stage 2
  - Significant deterioration in credit quality; and
  - Not ‘investment grade’
  - Rebuttable presumption met if more than 30 days past due
- Stage 3
  - Credit-impaired or incurred loss has occurred

Expected credit losses are updated at each reporting date for new information irrespective of whether a financial instrument stays at the same ‘stage’

What are 12-month expected credit losses?

- Proxy for adjusting interest rate for initial expected credit losses
- Expected shortfall in <u>all</u> contractual cash flows given probability of default occurring in next 12 months
- *<u>NOT</u>*: – Expected cash shortfalls in next 12 months
  – Credit losses on assets expected to default in next 12 months
- Example:
  - Portfolio of 10m loans
  - Expect 2% to default in next 12 months
  - Entire loss that would arise on default is 10%

➡ 12-month expected loss = 20,000 (2%x10%x10m)

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Information used and measurement

- Information used to measure expected credit losses and assess changes in credit:
  - Available without undue cost or effort
  - Historical, current and reasonable and supportable forward looking information
  - Historical information must be updated
  - Delinquency information may be used
- Information that can be considered includes:
  - Borrower specific
  - Macro-economic
  - Internal default rates and probabilities of default
  - External pricing
  - Credit ratings

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Expected credit losses

Need to estimate credit losses reflecting:

- Probability weighted outcome
  - Must consider (at least) possibility that a default will occur and that a default will not occur
- Time value of money
  - Reasonable rate between (and including) risk-free rate and effective interest rate

Estimation will be less difficult for 12-month expected credit losses because of the shorter time horizon

Assessment of deterioration in credit quality

Need to assess when significant deterioration has occurred:

- Change in probability of default occurring (not change in expected losses)
- Compared with initial recognition
- Particular measurement methods not prescribed; nor must PD be explicitly included as input
- Maturity matters
- Operational simplifications:
  - Recognise 12-month expected credit losses if investment grade
  - Rebuttable presumption: significant deterioration when payments are more than 30 days past due
  - Don’t need to assess for trade and lease receivables

When to calculate net interest

- Interest is usually calculated on the gross carrying amount ie before the loss allowance
- Change to calculation on a net basis (ie on the amortised cost amount that is net of the loss allowance) when IAS 39 criteria for impairment are satisfied
- Consistent with population considered impaired under IAS 39 today (excluding IBNR)

Credit-impaired on initial recognition

- Applies to *originated* and *purchased* credit-impaired financial assets
- Always outside the general model
- Use *credit-adjusted effective interest rate*
  - No day 1 allowance balance
  - No day 1 impairment loss recognised
- Allowance balance always represents *changes* in lifetime credit loss expectations

Simplified approach for trade and lease receivables

***Do not* constitute a financing transaction (eg short term):**

- Allowance is always lifetime expected losses
- Provision matrix can be used

***Do* constitute a financing transaction (eg long term) and lease receivables:**

- Policy election:
  - general model or
  - always recognise lifetime expected losses

Loan commitments and financial guarantee contracts

Apply general deterioration model

- Instruments that create a present legal obligation to extend credit
- Longest period considered is contractual period exposed to credit risk
- Estimate usage behaviour
- Expected credit losses presented as liability on the balance sheet

Disclosures

- Amounts arising from expected credit losses:
  - reconciliation for gross carrying amount and loss allowance
  - inputs and assumptions used to measure 12-month and lifetime expected credit losses
  - write-offs; modifications; collateral
- Effect of the deterioration and improvement in the credit risk of financial instruments:
  - carrying amount by credit risk rating grades
  - inputs and assumptions used in determining whether a significant increase in credit risk has occurred
  - carrying amount of assets evaluated on individual basis

Transition

- On transition determine if instruments are at stages 1, 2 or 3 *unless* not possible to determine initial credit quality without undue cost or effort
  - If initial credit quality not used, always evaluate based whether or not 'investment grade'
- Permit but not require restatement of comparatives
- Reconciliation of impairment allowances under IAS 39 and IFRS 9

Questions or comments?

Expressions of individual views by members of the IASB and
its staff are encouraged.
The views expressed in this presentation are those of the presenter. Official positions of the IASB on accounting matters are determined only after extensive due process and deliberation.