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IFRS Developments

ITG discusses IFRS 9 impairment implementation issues

What you need to know

ITG members discussed a number of implementation issues at the September 2015 meeting, reaching agreement on a number of items, such as:

- The limitations in the use of pricing and behavioural indicators in assessing if there has been a significant increase in credit risk
- The need for a periodic reassessment of whether a 12-month PD is a reasonable approximation of lifetime PD
- Limiting the exposure on revolving facilities to the contractual limit

Overview

On 16 September 2015, the Transition Resource Group for Impairment of Financial Instruments (ITG) held its third meeting to discuss four implementation issues on the new expected credit loss (ECL) impairment requirements of IFRS 9 *Financial Instruments*.[1]

The International Accounting Standards Board (the IASB) set up the ITG to provide a discussion forum for stakeholders on implementation issues arising from the new impairment requirements that could create diversity in practice, as well as to assist the IASB to determine what action, if any, is needed to address any issues. However, the ITG will not issue any guidance.

The IASB plans to provide a summary of the implementation issues discussed during this ITG meeting. The final meeting for this year is scheduled for 11 December 2015. The IASB is prepared to reconvene the ITG in 2016, if needed, although no meetings are currently scheduled. Constituents are requested to submit issues to the IASB by 21 October for consideration at the 11 December meeting.

[1] See our recent publications, *Applying IFRS – Impairment of financial instruments under IFRS 9*, *IFRS Developments Issue 105: The ITG discusses IFRS 9 impairment implementation issues*, *IFRS Developments Issue 100: Basel Committee proposes guidance on accounting for expected credit losses* and *IFRS Developments Issue 87: IASB issues IFRS 9 Financial Instruments – expected credit losses*

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Implementation issues discussed

Significant increases in credit risk

The ITG discussed two issues concerning how an entity should determine whether there has been a significant increase in credit risk:

1. 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 (common to many retail loan portfolios).
2. The possibility of using behavioural indicators of credit risk for the purpose of the assessment of significant increases in credit risk since initial recognition.

Pricing alone is not a determinative factor.

ITG members generally agreed that pricing alone is likely not a determinative factor in assessing a significant increase in credit risk.[2] If, within the same portfolio, there are customers with significantly different credit risks at origination, an entity cannot disregard this fact. ITG members suggested two possible ways of assessing whether significant increases in credit risk have occurred. First, an entity could achieve greater granularity by segmenting portfolios by groups of loans with shared credit risk characteristics.[3] Second, an entity could design more sophisticated indicators that take into account different initial credit qualities within the same collectively assessed portfolio.

The ITG members generally agreed that behavioural indicators can only be used on their own to asses a significant increase in credit risk if a correlation can be established between the behavioural indicators and the risk of a default occurring.[4] ITG members noted that behavioural indicators are usually backward looking and an entity will also need to consider forward-looking information, possibly through a collective approach. Whatever the approach, it should aim to ensure that exposures move to Stage 2 before they become delinquent.[5] Also, the majority of ITG members were in general agreement that behavioural information should not rely solely on an entity's own experience, but should make use of other readily available credit information, such as credit bureaux data, if available.

Other behavioural indicators, beyond those mentioned in the IASB Staff Paper, 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.

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

In making an assessment of whether there has been a significant increase in credit risk, an entity must use the change in the risk of a default occurring over the expected life of the financial instrument.[6] Despite this, the standard says 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."[7]

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[2] IFRS 9.5.5.4
[3] IFRS 9.B5.5.5
[4] In accordance with IFRS 9.5.5.4 and 5.5.9
[5] IFRS 9.B5.5.2
[6] IFRS 9.B5.5.9
[7] IFRS 9.B5.5.13

Estimated future draw downs on revolving facilities should not exceed the contractual limit.

The standard also states that the use of this practical expedient may not be suitable when[8]:

- 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
- 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.

The submitter asked whether an entity would be required to perform an annual review to determine whether circumstances still support the use of the 12-month probability of default (PD) as an approximation of changes in the lifetime PD.

The ITG members agreed that there has to be some method of periodic reassessment of whether a 12-month PD is a reasonable approximation of lifetime PD. There was no consensus on how to perform the subsequent reassessments, other than they do not need to be solely quantitative exercises.

Most ITG members agreed that while a 12-month PD could possibly be used for assessing significant increases in credit risk, it is not suitable as a proxy for lifetime PDs when measuring lifetime credit losses. Entities will still need to calculate a lifetime PD when assets are in Stage 2 or Stage 3.

Measurement of expected credit losses for revolving credit facilities

The ITG 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.

Some ITG participants wanted to reflect the ultimate economic risk of loss, regardless of what is contractually agreed. However, there appears to be no support in the standard for including amounts in excess of the limits.

Some ITG members noted that a limit is not always explicitly stipulated in the contract. There was no consensus on how to deal with these circumstances, although one member suggested looking at what the bank has internally established as a limit in its systems or credit policies. This issue has been flagged to the IASB for further consideration.

Forward-looking information

The ITG examined two questions about the use of forward-looking information:

1. At what level should forward-looking information be incorporated – at the level of the entity or on a portfolio-by-portfolio basis[9]
2. How to determine what is “reasonable and supportable” forward-looking information[10] and how to treat shock events with material, but uncertain, economic consequences

ITG members agreed that forward-looking information should be assessed at the level that matters and is relevant given the granularity of the information under consideration; this should be as granular as is necessary but will require entities to understand the significant drivers of losses.

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[8] IFRS 9.B5.5.14
[9] IFRS 9 B5.5.16
[10] IFRS 9 B5.5.49 to B5.5.54

On the second question, ITG members seemed to largely agree that a balance needs to be struck between:

a) Inappropriately excluding information that is relevant (and perhaps presenting opportunities for abuse or delays in recognition)

And

b) Considering all views on future possibilities, including those of a speculative nature that have little or no basis (and may be considered unsupportable)

Some ITG members generally agreed that shock events for which the expected loss consequences cannot be reliably estimated should be rare. For most events, it should be possible to estimate and incorporate their consequences in the measurement of expected credit losses. If it is concluded that it is not possible to determine the loss consequences then, at the very least, that conclusion and the event should both be disclosed. Entities should make their best efforts, on a good faith basis, to establish the expected losses associated with shock events. In the first instance, this will inevitably be an approximation, but should be at least directionally consistent with the change in the risk. The measurement of this estimate will need to be refined as more information about the event and its consequences becomes available.

It was also noted that, in calculating the effect of shock events, it is important not to double count what may have already been built into longer-term macroeconomic forecasts, if they already anticipate more generic shocks and unknown events. However, larger shocks may ultimately require separate consideration.

ITG members also generally agreed that a structured approach should be consistently applied to shock events and that the judgements should be adequately documented, including how conclusions about whether items did or did not require separate consideration were determined. Good governance and control is required to manage this process.

Basel Committee for Banking Supervision (BCBS) update

During meeting, the BCBS Observer at the ITG provided an update on the BCBS's revisions to their guidance on credit risk and IFRS 9 implementation. She confirmed that the BCBS guidance will only apply to internationally active banks and will continue to prohibit the use of certain practical expedients offered in IFRS 9. She also confirmed that no disclosure requirements will be included in the BCBS guidance. The BCBS will leave further guidance on disclosures to regulators and the Enhanced Disclosure Task Force (EDTF). The draft of the guidance is expected to be presented to the Basel Committee for review and approval soon. The BCBS has sought to ensure that the guidance does not conflict with US GAAP and IFRS and will forward it to the FASB and IASB before publication for a final "fatal flaw" review. The final BCBS guidance on credit risk and IFRS 9 implementation is expected to be published in October or November.