Of "Great Expectations"—Accounting for Expected Credit Losses in Financial Instruments

7 March 2013

In early March we published a set of proposals dealing with the accounting for credit losses on financial instruments. Specifically, the proposals establish how and when an entity should recognise "expected" credit losses on financial instruments and on commitments to extend credit. This would be accomplished by requiring estimates of expected credit losses, and changes in the expectations about credit losses, using a broad range of reasonable and supportable information to make estimates. Unlike current IFRS, these new proposals would introduce a single expected credit loss approach for all debt instruments (loans or securities) to recognise and measure impairment of financial instruments, irrespective of whether those instruments are reported at amortised cost or at fair value through Other Comprehensive Income (FVOCI).[1] A key benefit of these proposals for investors is the ability to see through the eyes of the reporting entity how financial instruments have deteriorated in credit quality. That is, an investor will receive information about expected credit losses that distinguishes between loss expectations at origination or purchase and changes from those original loss expectations. We believe investors will receive a better picture of changes in the value of a portfolio of financial instruments caused by changes in credit quality as both economic conditions and new loan issuance levels change, compared to other proposals in which those changes are not as easily distinguishable.

We define expected credit losses as the difference between the present value of the expected cash flows (principal and interest) that are contractually due and the present value of the cash flows the entity (investor) expects to receive taking into consideration the estimates of probability of default. Entities would recognise those expected credit losses as of the reporting date as a loss allowance (a contra-asset) against a financial instrument or, in the case of a commitment, as a provision.

How do the proposals differ from current IFRS?

The single biggest change in these proposals compared with current IFRS is that the amount and timing of recognition of credit losses would no longer depend on when an entity identifies a credit loss event—known as an incurred loss. In fact, one of the greatest concerns voiced by investors and regulators in the midst of the global financial crisis was the delayed recognition of credit losses in reported financial information. Many believe that delayed recognition was a function of current accounting standards that require the identification of a loss event before a charge to income can be recognised. Our proposals eliminate this recognition threshold—expected credit losses are always recognised and updated for changes in credit loss expectations. Moreover, our proposals broaden the information to consider because the estimate of expected credit losses would be based on all available and relevant information about past loss experience, current conditions, and reasonable and supportable forecasts of future collectible cash flows. It is not limited to credit losses that arise from past events and current conditions as in IFRS today.

The proposals

An entity would make an estimate of the expected credit losses on financial instruments each time it prepares a balance sheet. It would do so by making estimates of the cash flows it does not expect to collect. This estimate could be applied to an individual financial instrument or a portfolio of instruments, assuming the portfolio comprises instruments with similar credit risk characteristics.

There are three stages in the process of recognising expected credit losses for financial instruments and, for financial assets, the calculation and presentation of interest revenue in accordance with the new proposals. The reason for those stages is principally to distinguish changes in credit quality.

- The first stage involves identifying financial instruments that *have not deteriorated significantly since they were first recognised* or that have low credit risk at the reporting date, for example, because they have 'investment grade' characteristics. For these instruments 12-month expected credit losses would be recognised. That

is, an estimate would be made of the probability of a default occurring in the 12 months following the reporting date. That probability would be multiplied by the shortfall in lifetime cash flows (that is, the present value of the difference of all principal and interest contractually due and the amount the entity expects to receive). In essence, the 12 month expected credit losses represent a portion of the lifetime credit losses. Interest revenue would be calculated on the gross carrying amount (ie the amount that is not reduced for expected credit losses) for instruments at this stage.

- *The second stage involves identifying financial instruments that have deteriorated significantly in credit quality since they were first recognised— unless they have low credit risk at the reporting date, and do not exhibit objective evidence of a credit loss event.* For these instruments, lifetime expected credit losses would be recognised; interest revenue would still be calculated on the gross carrying amount for these instruments. In contrast to 12-month expected credit losses, lifetime expected credit losses represent estimates based on the probability of a default event occurring at any time over the life of an instrument and is not only weighted by the likelihood of possible default events over the next 12 months.

- *The third stage* is for those financial instruments that *do show objective evidence of impairment at the reporting date.* For such instruments, lifetime expected credit losses are recognised, but unlike for financial assets in Stages 1 or 2, the interest revenue on these assets is calculated on the net carrying amount (ie the gross carrying amount less the loss allowance for expected credit losses).

An outcome of the approach summarised above is that upon initial recognition of a financial asset, a loss allowance would be established equal to 12-months of expected credit losses. We adopted this approach to

help investors better understand the initial loss expectations of an entity and as a proxy for adjusting the contractual interest rate for expected credit losses. Some might argue such an allowance is unnecessary because it is already included in the rate charged to the borrower. However, we believe recognising 12 month expected credit losses and then lifetime expected credit losses when credit risk increased significantly better approximates the true economics with a more timely recognition of credit losses in a cost efficient way.

We believe that entities will be able to use the risk management systems that they already have in place to apply the above guidance, but they may have to track new data to capture changes in credit quality and, thus, report the kind of information that investors have told us is so critical to understanding the amount, timing and uncertainty of credit losses.

We have heard from entities that the process of assessing what constitutes significant deterioration in credit quality (or essentially when an instrument passes from Stage 1 to Stage 2 as described above) will be challenging because it will require the use of judgement. However, we believe that this challenge, and the associated complexity that comes with it, is outweighed by a model that distinguishes assets that have deteriorated significantly in credit quality from those that have not. It is also much more responsive to recognising changes in credit conditions compared to current accounting guidance. As a practical matter, we have included a rebuttable presumption in the proposals that states when contractual payments are more than 30 days past due, a *significant deterioration* in credit risk is deemed to have occurred.

To illustrate how we believe these concepts would be applied to financial instruments such as loans or debt securities, let's examine a few examples involving a reporting entity, Bank ABC.

Example 1

Bank ABC provides mortgages to finance residential real estate. During the last quarter of 20X2, Bank ABC originates a portfolio of 1,000 loans for CU1,000 each (ie CU1,000,000 in total). The portfolio comprises loans with loan-to-value (LTV) ratios of approximately 75 per cent. At December 31, 20X2, it estimates that there is an average 0.5 per cent probability of a default occurring (PD) in the next 12 months for the portfolio, and an average LGD of 25 per cent (excluding the time value of money). No

individual loan has yet been identified as having different risk characteristics from the rest of the portfolio, so Bank ABC assesses that the PD and LGD of the portfolio equals the PD and LGD of each item. On December 31 20X2 Bank ABC recognises a loss allowance equal to 12-month expected credit losses based on the average 0.5 per cent 12 month PD. Implicit in the calculation is the 99.5 per cent probability that there is no default.

The loss allowance for the 12-month expected credit losses is CU1,250 (0.5% × 25% × 1,000,000).

Example 2

During 20X4, Bank ABC observes that economic conditions have deteriorated significantly. Unemployment levels have increased and the value of residential property has decreased, causing the LTV ratios to increase. Bank ABC also expects default rates on the mortgage portfolio to increase.

Bank ABC assesses each of its mortgage loans on a monthly basis by means of an automated behavioural scoring process. Its scoring models are based on current and historical past-due statuses, levels of customer indebtedness, LTV ratios, customer behaviour on their other loans with Bank ABC, the loan size and the time since the origination of the loan. Bank ABC has historical data that indicates a strong correlation between the value of residential property and the default rates for mortgages.
For each loan, Bank ABC assesses the probability of a default occurring by monitoring behavioural scores and past-due statuses. Bank ABC considers that there has been a significant increase in credit risk since initial recognition if there has been a significant decrease in the behavioural score or if the mortgages are more than 30 days past due. For loans meeting either of these criteria, a loss allowance at an amount equal to lifetime expected credit losses is recognised. For all other loans the amount of 12 month expected credit losses is updated.

Bank ABC uses the LTV measures to estimate the severity of the loss, ie the LGD. The higher the LTV measure, the higher the expected credit losses, all else being equal.

Example 3

Bank ABC holds a public bond in Company A, which is a large, listed company.

Company A has only one debt in its capital structure, which is a five-year public bond. The only bond covenant is a restriction on further borrowing. Company A reports quarterly to its shareholders.

Bank ABC makes an initial credit assessment that the bond is subject to low credit risk. Bank ABC recognises a loss allowance at an amount equal to 12-month expected credit losses.

The main credit concern is the continuing pressure on the total volume of sales that has caused operating cash flows to decrease.

Because Bank ABC relies principally on quarterly public information, it does not have access to private credit information (because it is a bond investor rather than a bilateral lender). Its assessment of changes in credit risk is tied to public announcements and information, including updates on credit perspectives in press releases from various market observers, including credit rating agencies.

Subsequent to initial recognition, Bank ABC evaluates again whether the bond has a low credit risk at the reporting date, using all reasonably available and supportable information. In making that evaluation, Bank ABC concludes that its internal rating of the bond is not equivalent to investment grade because of Company A's declining revenues and profit margins, and because Company A's external credit rating was placed under review for possible downgrade, the outcome of which could reasonably lead to a non-investment-grade rating.

While Company A currently has the capacity to meet its commitments, the large uncertainties arising from its exposure to adverse business and economic conditions may lead to it defaulting on the bond. As a result of the signs of weakened credit quality, Bank ABC assesses that the credit risk of Company A's bond has increased significantly since initial recognition. Consequently, Bank ABC would recognise a loss allowance at an amount equal to lifetime expected credit losses for the bond.

How do the proposals differ from current IFRS?

We believe our proposals will provide more timely and accurate signals about an entity's current estimates of expected credit losses and the changes in those estimates over time. Moreover, they will also include a comprehensive package of disclosures that would help investors understand the judgements, assumptions and information used by an entity in developing its estimates of expected credit losses. Obviously, the extent to which our proposals help to bridge the expectation gap between when investors believe economic losses occur and when they are recognised for financial reporting purposes will depend on the faithful and effective application of the principles discussed here.

What are your views? We look forward to hearing your opinions!
The Exposure Draft Financial Instruments: Expected Credit Losses is available on the IASB website.

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Comments are due by 05 July 2013. You can provide your comments by either:

- submitting a comment letter through our website; or
- arranging a conference call or meeting through the investor liaison.

1 FVOCI is a new mandatory measurement category that is proposed in the Exposure Draft ED/2012/4 *Classification and Measurement: Limited Amendments to IFRS 9*. The Exposure Draft *Classification and Measurement: Limited Amendments to IFRS 9* is available on the ifrs.org website