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**

Expected credit losses will be recognised at *all* times.

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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 (simplified approach applicable)
- Some loan commitments and financial guarantee contracts

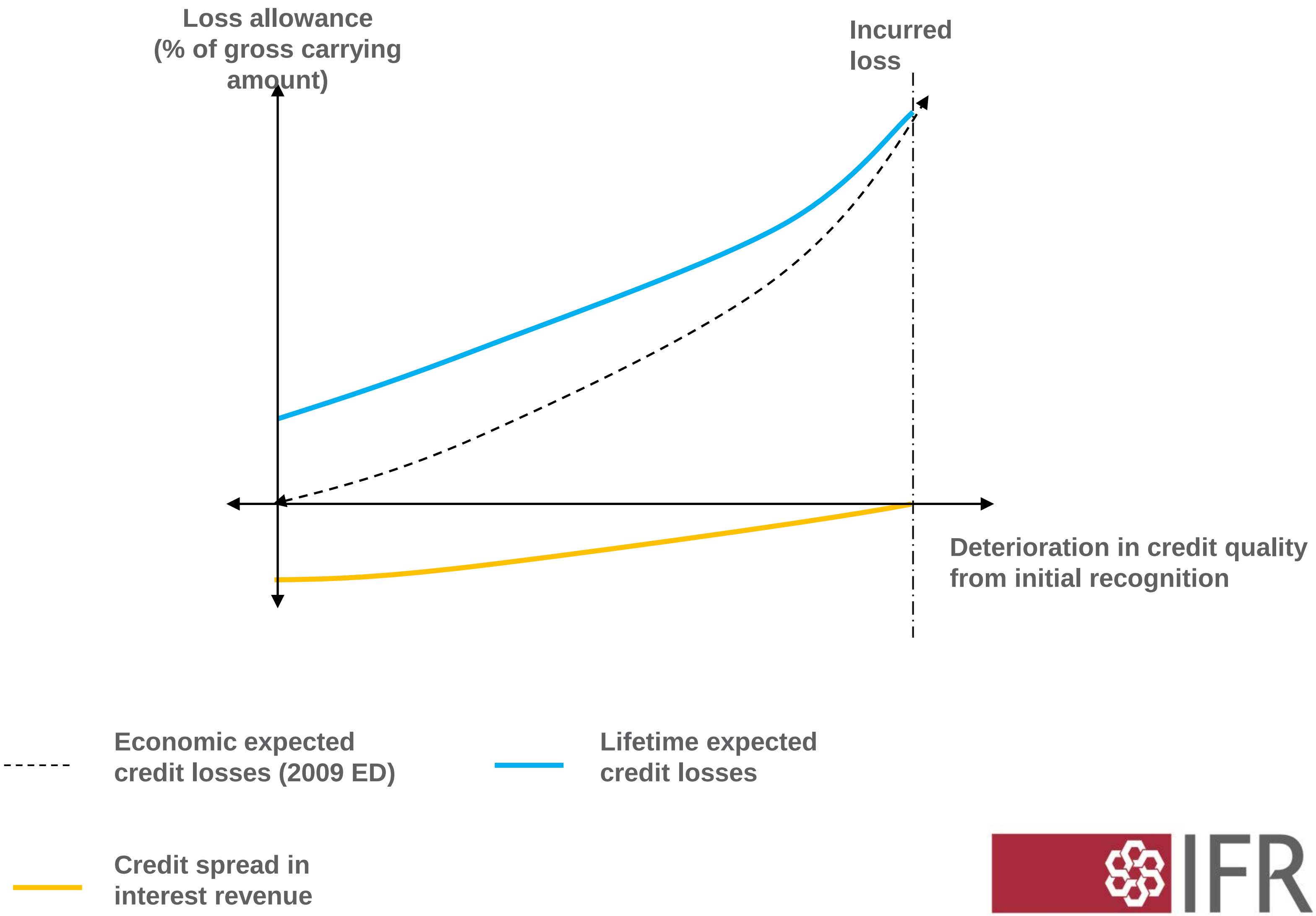
One model for all of these exposures to credit risk

Overview of general model

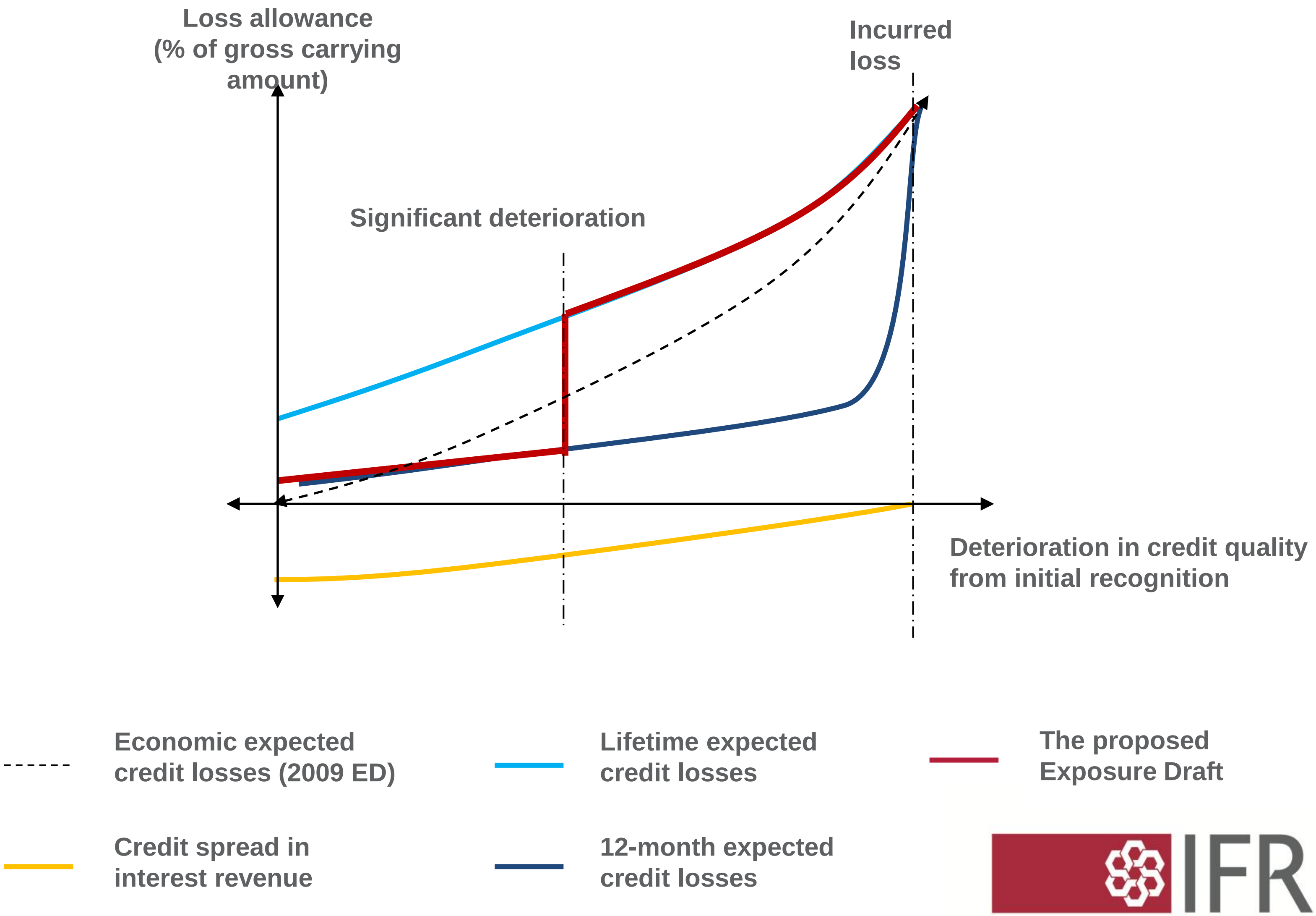
Change in credit quality since initial recognition

	Stage 1	Stage 2	Stage 3
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

Expected credit losses



Expected credit losses—as proposed



What are 12-month expected credit losses?

- Proxy for adjusting interest rate for initial expected credit losses
- Expected shortfall in all contractual cash flows given probability of default occurring in next 12 months
- *NOT*: – Expected cash shortfalls in next 12 months
  – Credit losses on assets expected to default in next 12 months

Estimation will be less difficult for 12-month expected credit losses than lifetime expected credit losses

Assessment of significant deterioration

- Change in probability of default occurring (not change in expected losses) compared to initial recognition
- Maturity and initial credit risk 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

Recognition of full lifetime expected credit losses only after a significant deterioration in credit quality better represents the underlying economics

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Expected credit losses

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

Particular measurement methods are not prescribed; nor must PD be explicitly included as an input

Information to be considered

- Information used to measure expected credit losses and assess changes in credit:
  - Historical, current and reasonable and supportable forecasts
  - Historical information must be updated
  - Delinquency information may be used
- Information that can be considered includes:
  - Both borrower specific and macro-economic
  - Internal default rates and probabilities of default
  - External pricing and credit ratings

Use the best information that is available without undue cost or effort

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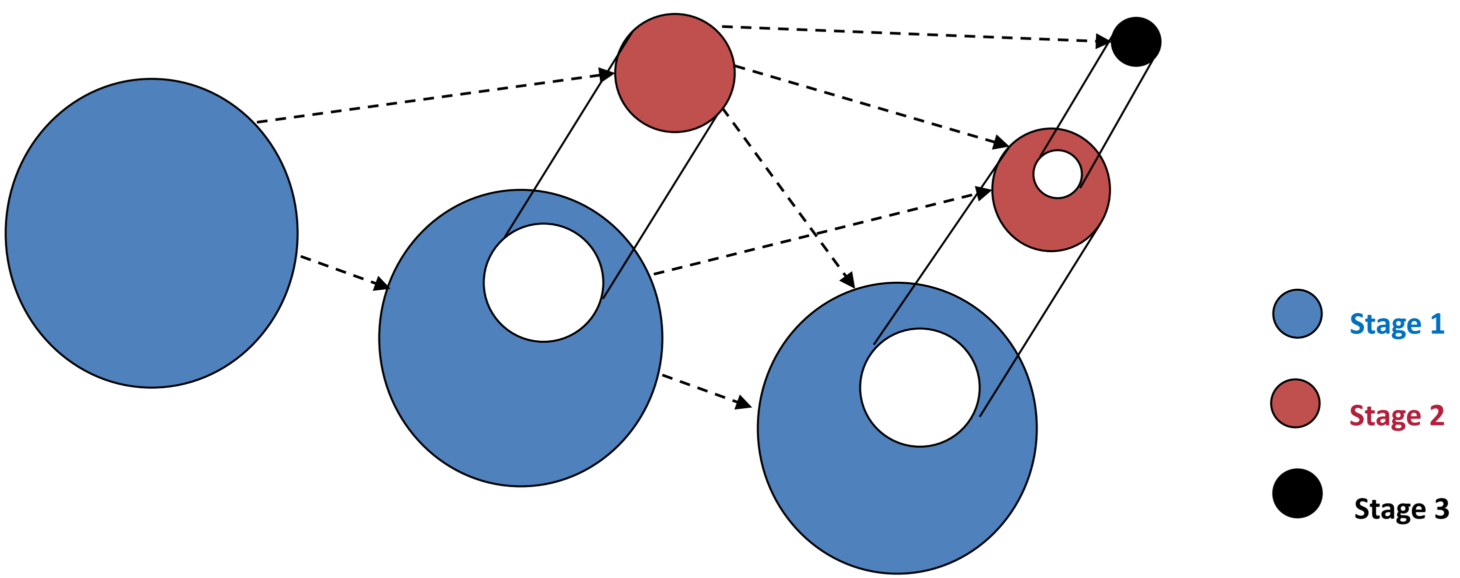
Expected credit losses—example

As information emerges over time – entity is able to better distinguish

Portfolio of home loans originated in a country.

Information emerges that a region in the country is experiencing tough economic conditions.

More information emerges and the entity is able to identify the particular loans that have defaulted or will imminently default.



Result

- Ensures a more timely recognition of expected credit losses than the existing incurred loss model
- Distinguishes between financial instruments that have significantly deteriorated in credit quality from those that have not
- Better approximates the economic expected credit losses

Exceptions to the general model

- Simplified approach for trade and lease receivables
  - Measure short-term trade receivables at lifetime expected losses
  - Policy election for long-term trade receivables and lease receivables
- Assets credit-impaired on initial recognition
  - Use credit-adjusted effective interest rate
  - Allowance balance represents changes in lifetime losses

Exceptions designed to achieve a better balance between the benefits and costs

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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.