

STAFF PAPER

28 October – 1 November 2013

REG IASB Meeting

Project	Financial Instruments: Impairment		
Paper topic	Assessing when to recognise lifetime expected credit losses		
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Purpose of the paper

1. The general impairment model proposed in the March 2013 Exposure Draft *Financial Instruments: Expected Credit Losses* (ED) uses different measurement objectives depending on whether the credit risk of financial instruments has increased significantly since initial recognition. A key objective of the ED was to recognise lifetime expected credit losses (ECL) on all financial instruments for which there have been significant increases in credit risk since initial recognition.
2. This paper includes feedback received on the ED and addresses:
 - (a) the timing of recognition of lifetime ECL (ie when to recognise lifetime ECL); and
 - (b) how to assess significant increases in credit risk (ie what entities should consider when assessing changes in credit risk).
3. This paper does *not* address:
 - (a) how to identify significant increases in credit risk since initial recognition when not evident at an individual exposure level in a timely manner (see Agenda Paper 5A of the September Board Meeting¹);
 - (b) the proposed operational simplifications for assessing whether lifetime ECL should be recognised; ie the low credit risk exception and the more

¹ Agenda paper 5A Responsiveness of the general model

than 30 days past due rebuttable presumption (see this month's Agenda Paper 5B); or

- (c) how to identify significant increases in credit risk since initial recognition for financial instruments that have been renegotiated or otherwise modified, but that do not result in a derecognition of the financial instrument (see this month's Agenda Paper 5D).

Background

4. The ED proposes that an entity shall measure an allowance for expected credit losses (or provision) at an amount equal to lifetime ECL when the credit risk on a financial instrument has increased significantly since initial recognition.
5. In making that determination, the ED proposes that an entity shall compare the initial credit risk of a financial instrument with the credit risk as at the reporting date, taking into consideration its remaining life and initial credit risk. However, an entity may consider the credit risk over the next 12 months instead of over the remaining life, if the information does not suggest that the outcome would differ.
6. The ED also proposes that an entity should consider whether there has been a significant increase in credit risk rather than an increase in the ECL (ie the assessment is based on changes in the probability of a default occurring).
7. The ED proposes that an entity shall consider the best information available that is relevant to credit risk when assessing increases in credit risk. To help with the assessment, the ED includes application guidance that sets out the types of information that can be used.
8. The ED is symmetrical, so it proposes that a loss allowance of 12-month ECL shall be re-established for financial instruments for which the criteria for the recognition of lifetime ECL are no longer met.
9. The vast majority of respondents supported these proposals but requested some clarifications about the assessment of significant increases in credit risk and some general clarifications on the operation of the model (eg if the model requires the specific calculation of the probability of default).
10. This paper considers the feedback received on these proposals as follows:

Issue A: whether to recognise lifetime ECL when the credit risk of a financial instrument has increased significantly since initial recognition.

Issue B: whether the proposals provide sufficient guidance on when to recognise lifetime expected credit losses.

Issue C: whether the assessment of when to recognise lifetime ECL should consider only changes in the probability of a default occurring, rather than changes in ECL (or credit loss given default (LGD)) and whether and when that assessment should be based on the lifetime probability of default or the 12-month probability of default.

Issue D: whether an entity shall re-establish the loss allowance (or provision) at an amount equal to 12-month ECL when the criteria for the recognition of lifetime ECL are no longer met

Staff recommendation

11. The staff recommendations for the IASB are as follows:

Issue A: (a) to confirm that lifetime ECL shall be recognised when there is a significant increase in credit risk since initial recognition; and

(b) to clarify that the assessment of significant increases in credit risk could be implemented more simply by establishing the initial maximum credit risk for a particular portfolio (by product type and/or region) (the ‘origination’ credit risk) and then comparing the credit risk of financial instruments in that portfolio at the reporting date with that origination credit risk. This would be possible for portfolios of financial instruments with similar credit risk on initial recognition. (So financial instruments from that portfolio (or region) with higher credit risk than the origination credit risk at the reporting date would be considered to have significantly increased credit risk).

Issue B: to confirm the guidance provided in the ED on how to assess changes in credit risk and provide clarifications to address the concerns on the operation of the model.

- Issue C:** (a) to confirm that the assessment of when to recognise lifetime ECL should consider only changes in the probability or risk of a default occurring, rather than changes in the amount of ECLs (or the credit loss given default (LGD)); and
- (b) to clarify that an assessment based on the change in the risk of a default occurring in the next 12 months is permitted unless circumstances indicate that a lifetime assessment is necessary and provide examples of when a 12-month assessment would not be appropriate and a lifetime assessment would be necessary.
- Issue D:** to confirm the proposal that a loss allowance measured at an amount equal to 12-month ECL shall be re-established for financial instruments for which the criteria for the recognition of lifetime ECL are no longer met.

Issue A: Recognising lifetime ECL when credit risk of a financial instrument has increased significantly since initial recognition

Proposals, reason for the proposals and Question asked in the ED

12. The ED proposes the following for the recognition of lifetime expected credit losses.

[Par. 5] At the reporting date, the entity shall measure the expected credit losses for a financial instrument at an amount equal to the *lifetime expected credit losses* if the credit risk on that financial instrument has increased significantly since initial recognition.

13. The Basis for Conclusions states the following reasons for the proposal in the ED:

[BC 69] The IASB considered how significant the extent of the deterioration in credit quality should be, from both an economic and practical perspective, to justify the recognition of lifetime expected credit losses. An entity initially accounts for a portion of expected credit losses. However, the IASB decided that, if an entity suffers a significant economic loss, recognition of only a portion of the lifetime expected credit losses is no longer appropriate, and it should recognise the full lifetime expected credit losses.

When developing the model jointly with the FASB, the boards had tentatively agreed that the deterioration criteria for the recognition of lifetime expected credit losses should be that the credit quality had deteriorated more than insignificantly subsequent to the initial recognition of the financial instrument. Outreach participants expressed concern that this criterion could lead to an instantaneous recognition of lifetime expected credit losses, with the result that even a minor change in the credit quality would satisfy the test. In response to that concern, this Exposure Draft proposes that the criterion for the recognition of lifetime expected credit losses is a significant increase in

credit risk, expressed as an increase in the probability of a default occurring after initial recognition.

14. The IASB asked respondents the following question in the ED:

Question 5

(a) Do you agree with the proposed requirement to recognise a loss allowance (or a provision) at an amount equal to lifetime expected credit losses on the basis of a significant increase in credit risk since initial recognition? If not, why not and what alternative would you prefer?

Feedback

15. The vast majority of respondents, including non-US users of financial statements, agreed with the proposal to recognise lifetime ECL when the credit risk of a financial instrument increased significantly, because it considers the underlying economics of a transaction while easing operational complexities. They agreed with the proposal because
- (a) it reflects and provides a clear indication that a significant economic loss occurred as a result of changes in credit risk from initial expectations;
 - (b) it avoids the excessive front-loading of ECL relative to recognising lifetime ECL at initial recognition;
 - (c) measuring lifetime ECL for financial instruments that have signs of significant increases in credit risk would be operationally simpler because more data is available compared to measuring lifetime ECL for all financial instruments (particular for long-dated exposures); and
 - (d) the proposal would result in recognising lifetime ECL in a more timely and forward-looking manner compared to IAS 39 *Financial Instruments: Recognition and Measurement*. They think that the proposal therefore addresses the concerns of the G20 about the delayed recognition of credit losses.
16. Although many preparers commented that they could build upon their internal credit risk management practices to identify significant increases in credit risk,

some of them made suggestions to align the proposals more closely with their current credit risk management systems. Suggestions included assessing a significant increase in credit risk on the basis of:

- (a) an absolute level of credit risk (ie lifetime expected credit losses would be required to be recognised on all financial instruments with credit risk higher than a particular level irrespective of their credit risk at initial recognition);
- (b) a change in the credit risk management objective for a financial instrument;
- (c) whether the credit risk of a financial instrument at the reporting date would be consistent with the entity's current credit underwriting policies; or
- (d) the increase in credit risk of the counterparty (instead of the increase in credit risk of the particular financial instrument).

17. Despite agreement by the vast majority of respondents with the proposals and the reasons for the proposals, some respondents disagreed with the proposal to recognise lifetime ECL on the basis of a significant increase in credit risk since initial recognition. However, many of their objections related to:

- (a) broader concerns about the overall model, such as for example keeping the existing incurred loss guidance for non-financial institutions or that an expected credit loss model should not be applied to financial instruments such as bonds. This will be discussed at a future meeting;²
- (b) specific application issues (see paragraphs 48-84 of this paper);
- (c) the concern that the model would probably be costlier to implement in jurisdictions, or for entities, that have less sophisticated credit risk management systems or that have little historical data to draw upon to estimate expected credit losses (eg where new products have been offered recently); or

² The simplified approach to trade receivables and lease receivables, as well as the issue of whether to apply the proposals to financial instruments measured at FVOCI, will be discussed at future meetings.

- (d) the misunderstanding that the proposals would disadvantage low credit quality lending, which could be addressed in the drafting of the final requirements.

Staff analysis

18. On the basis of the feedback, this section discusses:
- (a) the concern that the model would probably be costlier to implement in jurisdictions, or for entities, that have less sophisticated credit risk management systems or that have little historical data to draw upon to estimate expected credit losses (eg where new products have been offered recently); and
 - (b) the alternative approaches suggested to make the model operationally simpler (see paragraph 16 above).

Cost of implementation

19. While a few respondents raised the concern that it would be costlier to implement the proposals in some jurisdictions, and for some entities that have less sophisticated credit risk management systems, it is the staff's view that systems and processes that would be required are no more than those needed to manage the entity's business effectively.
20. In order to reduce the operational burden and cost of application for entities, the IASB already proposed the following in the ED, for the assessment of significant increases in credit risk:
- (a) a 'low credit risk' simplification;
 - (b) that entities may use past due information (in conjunction with more forward-looking information that is reasonably available without undue cost or effort);
 - (c) not requiring a specific approach for assessing whether there has been a significant increase in credit risk (see paragraph 58); and
 - (d) that significant increases in credit risk can be assessed on an individual instrument or a portfolio basis. In the September 2013 Board Meeting,

the IASB tentatively decided not to prescribe a specific method to assess significant increases in credit risk on a portfolio level, because entities have different information available and different levels of sophistication.

21. In addition, it is not the intention of the proposals that entities need to undertake an exhaustive search for information if they have little historical data. Instead, the intention of the proposal is that when assessing significant increases in credit risk entities shall consider all internal and external information that is reasonably available without undue cost or effort. This may mean that entities with little historical information would draw their estimates from internal reports and statistics (that may have been generated when deciding whether to launch a new product), information that they have about similar products or peer group experience for comparable financial instruments (see paragraph B20 and B6 of the ED).
22. Finally, the respondents who raised these concerns did not disagree with the effect analysis, which notes that implementing *any* expected credit loss model will require cost and effort.

Alternative approaches

23. During the development of the proposals in the ED the IASB considered alternative approaches for when to recognise lifetime ECL, to make the expected credit loss model simpler to apply.
24. This section summarises the alternative approaches proposed by respondents (see paragraph 16 above), considering separately those that the IASB has previously considered but rejected and those the IASB has not considered previously.

Alternative approaches previously considered but rejected

Absolute level of credit risk

25. Using this approach, an entity would recognise lifetime ECL on *all* financial instruments for which the credit risk is at or above a specified level at the

reporting date, including on originated or purchased financial instruments at market terms that are at or above the specified level of credit risk on initial recognition.

26. The respondents suggested this approach because credit risk management systems differentiate between financial instruments on the basis of their absolute level of credit risk at the date of evaluation. Thus the advantage is that this approach would align with current credit risk management systems. No assessment of the *change* in credit risk would be required, making the impairment proposals simpler to apply.
27. However, the IASB had already considered this approach and rejected it as stated in the Basis for Conclusions of the ED:

[BC67] The IASB considered whether lifetime expected credit losses should be recognised on the basis of an absolute assessment of the credit quality of a financial instrument at each reporting date. In contrast to an approach based on changes in credit quality, an approach based on the absolute credit quality at each reporting date would be much simpler to apply, because it adheres to existing credit risk management processes and is thus an approach that many preparers support. However, such an approach would provide very different information. Because it would not approximate the economic effect of initial credit loss expectations and subsequent changes in expectations, the IASB rejected this approach. In addition, if the absolute credit quality threshold for recognising lifetime expected credit losses was too low, too many financial instruments would be above the threshold and expected credit losses would be understated. If the absolute threshold was too high, too many financial instruments would be below the threshold, overstating the expected credit losses (for example, financial instruments with a low credit quality that an entity prices appropriately to compensate for the higher credit risk would always have lifetime expected credit losses recognised). Furthermore, depending on which absolute credit quality threshold is

selected, such an approach might be similar to the incurred loss model in IAS 39 (in which the absolute threshold is 'objective evidence of impairment').

Change in the credit risk management objective

28. Using this approach, lifetime ECL would be recognised when contractual cash flows are no longer as originally expected (eg a predetermined absolute level of credit risk would be met at the reporting date) and thus the asset would be monitored, or be expected to be monitored, on an individual basis (see for example the Comment letter from the Accounting Standards Board of Japan).
29. The staff think that this approach is somewhat similar to the approach proposed in the Supplementary Document *Financial Instruments: Impairment (SD)* which was published in January 2011. The SD required recognition of lifetime ECL if the collectability of a financial asset, or group of financial assets, becomes so uncertain that the entity's credit risk management objective for that asset, or group changes from receiving the regular payments from the debtor to recovery of all or a portion of the financial asset.
30. While recognising lifetime ECL when the credit risk management objective changes would be operationally simpler (ie financial instruments that are being managed differently would be identified rather than assessing a *change* in credit risk since initial recognition), the approach would be similar to the incurred loss model in IAS 39. The management of a financial instrument may only change relatively late compared with when significant increases in credit risk occur, so this may be a less timely approach to recognising lifetime ECL.
31. During its deliberations leading to the ED, the IASB also decided that the timing of recognition of lifetime ECLs should not be considered in isolation. Instead, to justify the recognition of lifetime ECL from an economic perspective and to better approximate the model in the 2009 Exposure Draft *Financial Instruments: Amortised Costs and Impairment* (2009 ED), the timing of recognition of lifetime ECL should be considered in combination with the amount of ECLs that are recognised for financial instruments that have not deteriorated significantly in credit quality. Thus the IASB thought that the balance between the timing of recognition of lifetime ECL and the measurement of ECL used for other financial

instruments should be considered (see Agenda Paper 5A of the November 2012 Board Meeting). The IASB concluded that a model that would recognise lifetime ECL later than the proposals in the ED but only recognise 12-month ECL for all other instruments, would neither sufficiently approximate the economic phenomenon nor the outcome of the 2009 ED. The Basis for Conclusions states in this respect:

BC30 The IASB considered the timing of recognition of the full lifetime expected credit losses together with the size of the portion of the lifetime expected credit losses that are recognised from initial recognition. The IASB considered the interaction between these decisions to be a determinant of what would provide a more faithful representation of the economic loss, and what would best approximate the outcome of the model in the 2009 ED. Thus, if an entity recognises a smaller portion of the lifetime expected credit losses initially, it should recognise the full lifetime expected credit losses earlier than if it were required to recognise a larger portion of the lifetime expected credit losses initially.

BC 33 The extent to which either model [ie the SD and the model proposed in the ED] approximates the outcome of the model in the 2009 ED depends on the pattern of changes in expected credit losses. The model proposed in this Exposure Draft results in a more timely recognition of the deterioration in credit quality. However, in the absence of significant deterioration in credit quality, an entity recognises a loss allowance at an amount equal to 12 month expected credit losses, regardless of the passage of time or the age of the financial instrument (or portfolio). The model in the SD results in a better allocation of the initial expected credit losses over time, but in the case of credit deterioration, an entity recognises lifetime expected credit losses later than it would when applying the model proposed in this Exposure Draft.

*Alternative approaches not previously considered**Credit underwriting policies*

32. Using this approach an entity would recognise lifetime ECLs on a financial instrument if the financial instrument's credit risk at the reporting date is higher than the credit risk at which the entity would originate new loans for that particular class of financial instruments. In other words, if the level of credit risk of a financial instrument at the reporting date exceeded the credit underwriting limit for this particular class of financial instruments, lifetime ECL would need to be recognised for the financial instrument.
33. This approach has similar advantages and disadvantages to an approach based on the absolute level of credit risk or an approach based on the change in the credit risk management objective:
- (a) this approach does not require the change in the financial instrument's credit risk since initial recognition to be evaluated to determine when to recognise lifetime expected credit losses (it is thus inconsistent with the IASB's objective of reflecting increases in credit risk and linking it with pricing).
 - (b) the objective of setting credit underwriting limits follows a different objective compared to the objective of financial reporting. The objective is typically to manage the overall business risk/return profile and can also be related to the entity's targets for its amount of lending and thus could result in either an understatement or overstatement of ECL for financial instruments. For example, similarly to the approaches discussed in paragraphs 25-27, a relatively high credit quality instrument could deteriorate a long way before lifetime ECL would be recognised.
 - (c) this approach may not be responsive enough, because it recognises lifetime ECL later than the proposals in the ED. Recognising lifetime ECL later than the proposals in the ED and recognising only 12-month ECL for all other instruments would not sufficiently approximate the outcome of the 2009 ED (see paragraph 31 above).

34. Finally, the entity's appetite for its business risk/return profile may affect allowance levels in a way that is disconnected from changes in credit risk. For example, if the entity increases its credit risk appetite and thus relaxes its underwriting criteria (for example because it wants to grow its business more aggressively) this may result in lifetime ECL allowances being recognised on *fewer* financial instruments even if credit risk has increased on financial instruments (but the credit quality as at the reporting date was still acceptable for the current underwriting standards).

Counterparty assessment

35. Using this approach an entity would recognise lifetime ECL on all financial instruments it holds with the same borrower if the credit risk of the borrower has reached a specified level at the reporting date (including on newly originated or purchased financial instruments at market terms). This approach is really more akin to an absolute approach, in that once the credit risk of a borrower reaches a particular level (or exceeds it) lifetime ECL would be recognised on all exposures to that borrower.
36. Respondents who suggested this approach manage credit risk at the counterparty and not at a facility level. This approach would therefore align with those respondents' risk systems. However, not all financial institutions manage credit risk at a counterparty level. In addition, some of our field participants who manage credit risk at counterparty levels found ways to deal with the difference between the counterparty credit risk at the reporting date (or its change) and the change in the credit risk of the financial instrument since initial recognition. Ultimately, they applied the proposed model at an instrument level and no longer stated this as an area of concern.
37. Respondents who suggested assessing significant increases in credit risk at the counterparty level also believe that assessing significant increases in credit risk at a facility level is counterintuitive. They believe it would produce counterintuitive results because a 12-month ECL allowance would be recognised for some financial instruments and other financial instruments would have a lifetime ECL allowance even though the exposure for all of the instruments is to the same counterparty. In the extreme, in theory two identical financial instruments could

have different allowance balances if the credit quality of the borrower was different at the point of initial recognition. However, an approach based on the level of credit risk of the counterparty would produce very different information compared to the information produced by the ED. It would result in an overstatement of ECL if the borrower were to issue a new financial instrument at market terms to (or held financial instruments that have not increased significantly in credit risk with) a counterparty who has reached (or exceeded) a specified level of credit risk.

38. Furthermore, like the absolute approach, depending on which level of credit risk is selected as the threshold for recognising lifetime ECL, this approach might be similar to the incurred loss model in IAS 39 (in which the threshold is “objective evidence of impairment”).
39. Finally, the objective of the proposal is to approximate the economics of lending in order to provide users of financial statements with relevant information about the performance of financial instruments and not about the performance of the borrower/counterparty. As a result, the amount of ECL to be recognised cannot be considered in isolation or be based on the level of credit risk of the counterparty. If Entity A lends to Entity B in 20X0 and then again in 20X1 those two financial instruments are not identical if Entity B’s credit quality was different in 20X0 and in 20X1 and Entity A has the opportunity to price those financial instruments differently. The ED sought to highlight this difference.
40. However, the staff note that assessing credit risk on a basis that considers a customer’s credit risk more holistically would not be inconsistent with the proposals in the ED. Paragraph B20 list the following indicators that could be considered when assessing whether lifetime ECL should be recognised:

[Par B20] (e) an actual or expected internal credit rating downgrade for the borrower or decrease in behavioural scoring used to assess credit risk internally. Internal credit ratings and internal behavioural scoring are more reliable when they are mapped to external ratings or supported by default studies;

(f) existing or forecast adverse changes in business, financial or economic conditions that are expected to

cause a significant change in a borrower's ability to meet its debt obligations, such as an actual or expected increase in interest rates or an actual or expected significant increase in unemployment rates;

(g) significant changes in operating results of the borrower. Examples include actual or expected declining revenues or margins, increasing operating risks, working capital deficiencies, decreasing asset quality, increased balance sheet leverage, liquidity, management problems or changes in the scope of business or organisational structure (such as the discontinuance of a segment of the business) that results in a significant change in a borrower's ability to meet its debt obligations;

(h) a significant credit deterioration on other financial instruments of the same borrower;...

41. The indicators listed above imply that when assessing the credit risk on a financial instrument, an entity should also consider other borrower-specific information. In other words, an entity should make a holistic assessment of credit risk. Such an approach is also consistent with the requirement in the ED to consider all reasonable and supportable information that is available without undue cost or effort.
42. The staff therefore believe that considering credit risk on a counterparty level when assessing whether lifetime ECL should be recognised, will not necessarily be inconsistent with the objectives of the proposed model. An overall assessment of the customer's credit quality could be undertaken for example to make an initial assessment of whether credit risk has increased significantly. However, care should be taken to ensure that the recognition of lifetime ECL is appropriate *for all financial instruments* held with the same borrower (For example recently recognised financial instruments may need to be treated differently to other financial instruments with the same counterparty)..

Staff recommendation

43. The basic concept in the ED (which is consistent with that in the 2009 ED) is that the loss allowance should differ based on the change in credit risk of a financial instrument compared with that at initial recognition. That basic concept has been supported in the feedback received on the current ED. In addition, we have received confirmation that the approach of making a distinction in the measurement and recognition of ECLs based on the concept of a significant increase in credit risk is generally operational.
44. **The staff therefore recommend that the IASB confirm the proposals in the ED that lifetime ECL shall be recognised when the credit risk of a financial instrument has increased significantly since initial recognition.** While operationally simpler, the alternative approaches have significant shortcomings:
- (a) the alternative approaches are not as responsive to changes in the credit risk as the proposals in the ED, risking lifetime ECL not being recognised on a timely basis;
 - (b) some of the alternative approaches could result in full lifetime ECL being recognised on initial recognition for some financial instruments; and
 - (c) all the approaches would produce very different information compared to the ED; failing to reflect the link between the initial expectations of credit risk and changes in those expectations.
45. However, the staff recommend that the IASB addresses the underlying operational concerns raised by some respondents by emphasising that the assessment of significant increases in credit risk could be implemented more simply by establishing the initial maximum credit risk accepted for a particular portfolio (by product type and/or region) (the ‘origination’ credit risk) and then comparing the credit risk of financial instruments in that portfolio at the reporting date with that origination credit risk. This would only be possible for portfolios of financial instruments with similar credit risk at initial recognition. (So financial instruments from that portfolio (or region) with higher credit risk than the origination credit risk at the reporting date would be considered to have significantly increased credit risk). Some referred to this during outreach as an

‘absolute’ application of the ED. This would enable a change in credit risk to be the basis for the recognition of lifetime ECL but does not require specific tracking at an individual instrument level.

46. Furthermore, the staff recommend that the application guidance be clarified to emphasise that the assessment of significant increases in credit risk can be implemented through a counterparty assessment as long such assessment achieves the objectives of the proposed model and the outcome will not be different to what it would have been if financial instruments have been individually assessed. This will be when the counterparty assessment neither delays the recognition of lifetime ECL for those financial instruments for which credit risk has increased significantly nor recognises lifetime ECL for financial instruments for which credit risk has not increased significantly.
47. During our outreach, this clarification alleviated the concerns of some preparers who were initially concerned about assessing the change in credit risk. In addition, during our fieldwork, some participants that applied the proposals in this way no longer stated that the assessment of a significant increase in credit risk since initial recognition was a significant area of concern.

Question 1

Does the IASB agree with the staff recommendation to:

- (a) confirm that lifetime ECL shall be recognised on the basis of a significant increase in credit risk since initial recognition;
- (b) clarify in the drafting of the final Standard that the assessment of significant increases in credit risk could be implemented by establishing the maximum credit risk accepted for a particular portfolio on initial recognition (by product type and/or region) (the ‘origination’ credit risk) and then comparing the credit risk of financial instruments in that portfolio at the reporting date with that origination credit risk; and
- (c) clarify in the drafting of the final Standard that the assessment of significant increases in credit risk can be implemented through a counterparty assessment as long such assessment achieves the objectives of the proposed model and the outcome would not be different to what it would have been if financial instruments have been individually assessed?

Issue B: Whether the proposals provide sufficient guidance on when to recognise lifetime expected credit losses.

Proposals, reason for the proposals and Question asked in the ED

48. The proposals in the ED require an entity to consider the following when assessing whether there has been a significant increase in the credit risk of a financial instrument:
- (a) the credit risk of the financial instrument at initial recognition;
 - (b) the remaining maturity of the financial instrument; and
 - (c) the best information available that might affect credit risk.
49. The ED includes application guidance in paragraph B20 (see Appendix A) that sets out the types of information that may be relevant when determining whether the recognition of lifetime ECL is required.
50. As stated in the Basis for Conclusions, the reasons for these proposals are:

[BC 71] This Exposure Draft proposes that the assessment of the significance of the change in the probability of a default occurring for different financial instruments would depend on the initial credit quality and the time to maturity. This is because it would be consistent with the structure of credit risk and therefore with the pricing of financial instruments. In the IASB's view, an entity should consider the term structure and the initial credit quality in assessing whether it should recognise lifetime expected credit losses. Doing so will improve the comparability of the requirements for financial instruments with different maturities and different initial credit qualities. For example, all other things being equal, a given increase (in absolute terms) in the probability of default reflects a greater deterioration in credit quality the shorter the term of the financial instrument and the higher its initial credit quality. This would also be consistent with the IASB's understanding of existing models for measuring credit risk, such as those underlying external credit ratings, option pricing models and their variants, including the models for measuring the

probability of default for the purposes of prudential regulatory requirements.

[BC72] If an entity were not required to consider the initial credit quality and time until maturity, the assessment would benefit shorter term financial instruments with low credit risk and would disadvantage longer term instruments with high credit risk. In addition, not reflecting the term structure might also result in the assessment that the probability of default has changed merely because of the passage of time, even if an entity had expected such a change at initial recognition. In the IASB's view, the assessment of the criteria should not change solely because the maturity date is closer.

....

To assist in the application of the lifetime expected credit loss criterion, the IASB has provided application guidance, including the types of information that an entity should consider. This Exposure Draft retains the previous proposals from the 2009 ED and the SD that an entity should use the best information that is available without undue cost and effort.

51. The IASB asked respondents the following question in the ED:

Question 5:

(b) Do the proposals provide sufficient guidance on when to recognise lifetime expected credit losses? If not, what additional guidance would you suggest?

Feedback

52. Many respondents supported the principle-based approach taken in the ED of providing indicators of a significant increase in credit risk rather than prescriptive rules and 'bright lines' about what constitutes a significant increase in credit risk.

53. Those respondents agree with the IASB that it would be inappropriate (if not impossible) to include prescriptive requirements. Instead, they agree that the assessment of a significant increase in credit risk should consider:
- (a) the credit risk at initial recognition;
 - (b) the type of financial instrument;
 - (c) the remaining maturity of the financial instrument; and
 - (d) current and expected economic conditions.
54. However, respondents noted some potential inconsistencies in the proposals of the ED and asked for clarification. In particular, although the proposals set out a range of information that could be considered, some respondents thought that the proposals as currently drafted could be interpreted to explicitly require the use of a probability of default (PD) approach when assessing significant increase in credit risk. Those respondents are concerned that this would require the explicit calculation and storage of the lifetime PD curve for a financial instrument to compare the expected remaining lifetime PD at inception with the remaining lifetime PD at the reporting date.
55. In contrast to the general level of agreement, some respondents, most notably some regulators and standard-setters, are concerned that allowing entities to use their internal risk management processes may lead to an assessment of whether there has been a significant increase in credit risk that is too judgemental and open to manipulation by the reporting entity. They are concerned that this would harm comparability and would lead to diversity in practice. Those respondents made the following suggestions:
- (a) to clarify the principle for when an increase in credit risk is significant. For example the Basel Committee of Banking Supervision, which sent comments prepared by the Committee's Accounting Expert Group, noted in their Comment letter "...the Board needs to set forth a principle governing the magnitude of change in credit risk that would be considered as significant. Paragraphs B20 (c) and (d) suggest considering internal price indicators of risk and comparing the instrument to the rates and terms of newly issued or originated loans. In our understanding, all else being equal, if an institution would not

make the same loan today on terms comparable to those on the loan when it was originated due to a meaningful increase in credit risk since origination, a transfer of a loan out of stage 1 and recognition of lifetime expected credit losses would be required”;

- (b) to provide clarification to the extent that some sources of information are stronger indicators for a significant increase in credit risk than others. Those respondents thought that it would be particularly helpful to provide more examples on how non-borrower-specific information (such as macroeconomic factors) would factor into the evaluation;
- (c) although the proposed application guidance should not be a ‘checklist’ and judgement should be used, to *require* consideration of these indicators because it would enhance enforceability, consistent application and comparability; and
- (d) to emphasise more explicitly that a significant increase in credit risk occurs earlier than non-performance or default.

56. Other specific suggestions to improve the guidance on assessing a significant increase in credit risk were also made by all types of respondents. However, these suggestions have either been already addressed in other Agenda Papers or will be addressed in future meetings or in drafting³.

Staff analysis and recommendation

57. On the basis of the feedback, this section discusses the concerns about the operability of the assessment of significant changes in credit risk in the model, ie the concern that:

³ The suggestions were: (a) being more explicit that all available information, including changes in macroeconomic factors, should be considered when the entity determines whether there has been a significant increase in credit risk (this was discussed in Agenda Paper 5A of the September Board meeting); (b) providing a definition of key terms such as ‘default’ (this was discussed in Agenda Paper 5D of the September Board meeting); (c) incorporating additional guidance on how to assess a significant increase in credit risk for revolving financial instruments (the staff plans to discuss with the IASB loan commitments and financial guarantee contracts at a future meeting); and (d) providing guidance on how to assess significant increases in credit risk for financial instruments with credit spreads that reset when the credit risk increases.

- (a) the proposals require determination of a probability of default (ie a mechanistic approach) to assess significant increases in credit risk; and
- (b) the assessment of a significant increase in credit risk becomes too judgemental and open to manipulation.

The staff are of the view that both concerns raised can be addressed through drafting. **The staff recommend confirming the guidance provided in the ED and providing clarifications to address the concerns about the operability of the model.**

58. It was not the intention of the ED to prescribe a specific or a mechanistic approach to assess whether there has been a significant increase in credit risk. In fact, prescribing a specific method would be contrary to the approach taken by the IASB throughout the development of the ED, whereby the IASB took into account different levels of sophistication of entities and different data availability. For example, the ED proposes that the estimates shall be based on information that is reasonably available without undue cost or effort and states in paragraph 18 that:

[a]n entity may apply various approaches when assessing whether the credit risk of a financial instrument has increased significantly since initial recognition.... An entity may apply different approaches for different financial instruments.

59. The reasons why the proposals in the ED explicitly refer to the probability of a default occurring was to emphasise that an entity shall consider the following when assessing whether the credit risk of a financial instrument has increased significantly since initial recognition:
- (a) the *risk* of a default occurring (rather than referring to a specific measurement technique);
 - (b) the change in the risk of default occurring (as opposed to the change in the amount of the ECLs);
 - (c) the credit risk over the remaining life (ie maturity matters); and
 - (d) the initial credit risk on the financial instrument.

60. All of the above still hold but the intention was not that an entity is required to calculate an explicit PD to apply the model.
61. The staff are of the view that respondents' concerns that the assessment would be based on judgement and would be open to manipulation could be addressed in drafting. The final Standard:
- (a) could *require* that the indicators that are *relevant* for the particular financial instrument being assessed must be considered when assessing a significant increase in credit risk;
 - (b) could place more emphasis on the fact that a significant increase in credit risk occurs earlier than non-performance or default⁴;
 - (c) could state the principle underlying the focus on the significant increase in credit risk more prominently in the application guidance⁵—ie that a significant increase in credit risk may have occurred when rates or terms of existing financial instruments would be different because of changes in credit risk if the financial instrument were to be newly originated or had been issued at the reporting date; and
 - (d) will provide examples on how non-borrower-specific information (ie macroeconomic information) would factor into the assessment of a significant increase in credit risk, as tentatively decided by the IASB in its September Board meeting.
62. However, the staff do not believe that clarification can be provided about which sources of information are stronger indicators of credit risk than others (see paragraph 55). That is because:
- (a) credit-analysis is a multifactor and holistic analysis—whether a specific factor is relevant, and its weight compared to other factors will depend on the type of product, characteristics of the loan and borrower as well as the geographical region.

⁴ Also refer to Agenda Paper 5X *Operational Simplifications* of this month's meeting

⁵ The staff do not think the underlying principle could be further elevated to the main part of the final Standard because credit risk managers do not generally monitor pricing to assess credit risk.

- (b) Entities have differences in the availability of data. This means that we cannot prescribe the factors to be considered.

Question 2

Does the IASB agree with the staff recommendation to confirm the guidance provided in the ED and to provide clarifications to address the concerns about the operation of the model as discussed in paragraphs 52-56?

Issue C: *Assessment of a significant increase in credit risk based on changes in the probability of a default occurring, rather than changes in ECL (or credit loss given default (LGD))*

Proposals, reason for the proposals and question asked in the ED

63. The ED included the following:

[Par. 8] When assessing whether the credit risk on a financial instrument has increased significantly since initial recognition ..., an entity shall use the change in the probability of a default occurring on the financial instrument rather than the change in the expected credit losses. To make that assessment, an entity shall compare the probability of a default occurring over the *remaining life* of the financial instrument as at the reporting date with the probability of a default occurring on the financial instrument over its remaining life as at initial recognition.

[Par. B11] ... An entity shall use the lifetime probability of a default occurring when deciding whether the credit risk has increased significantly since initial recognition. However, an entity may use the 12-month probability of a default occurring to determine whether credit risk has increased significantly since initial recognition if the information considered does not suggest that the outcome would differ.

[BC69] The IASB has used the increase in credit risk that is determined by assessing the probability of a default occurring on the financial instrument to decide when an entity shall recognise lifetime expected credit losses. The IASB has proposed this because the probability of a default occurring is a measurement of the financial instrument's credit quality that does not require the full estimation of the expected credit losses. The 2009 ED would have required the tracking of the initial expected credit losses and the measurement of subsequent changes

in those expected credit losses. The proposed model does not require this but will require:

- (i) the tracking of the initial probability of a default occurring (a component of the expected credit losses); and
- (ii) an assessment of the significance of subsequent changes in the probability of default to decide whether the recognition of lifetime expected credit losses is required.

Views from participants in the outreach performed by the IASB indicated that using the probability of a default occurring on the financial instrument as the measure of credit risk would be less costly to track than using expected credit losses, because it adheres to existing credit risk management processes. Credit risk managers have told the IASB that they use the probability of default, instead of expected credit losses, to assess credit quality in their internal credit risk management processes.

[BC73] Ideally, an entity should use changes in the lifetime probability of a default occurring to assess changes in credit risk. However, because of the difficulty in estimating lifetime probabilities of default, this Exposure Draft permits the use of 12 month probabilities of default when making the assessment, if appropriate. The IASB observed that, typically, a change in the 12 month probability of default would indicate a change in the lifetime probability of default, and thus would not be inconsistent with the requirements. Furthermore, because such a measurement is commonly used in prudential regulatory requirements, allowing the use of a 12 month probability of default will allow some financial institutions to use existing systems (with some adjustment) thus reducing the costs of implementation.

64. The IASB asked the following question in the ED:

Question 5

(c) Do you agree that the assessment of when to recognise lifetime expected credit losses should consider only changes in the probability of a default occurring, rather than changes in expected credit losses (or credit loss given default (LGD))? If not, why not and what would you prefer?

Feedback

65. Most respondents agree that an assessment of when to recognise lifetime ECL should only take into consideration the changes in credit risk (ie the risk of a default occurring) rather than changes in ECL (ie the severity of the loss). Although some stated that other factors (such as LGD) do affect the assessment of increases in credit risk, they supported the proposal in the ED because:
- (a) they consider the probability (ie risk) of a default as the most relevant factor in assessing credit risk; and
 - (b) tracking only the probability of a default occurring makes the model more operational and less costly to apply because an assessment based on the probability generally aligns with their credit risk management.
66. However, a few respondents disagreed with the proposal in the ED. They stated that in an expected loss model, a movement to lifetime ECL should not be based solely on the risk of a default occurring but should also be based on changes in the ECL (ie including LGD). However, these are not new arguments and during the development of the proposals, the IASB had already considered recognising lifetime expected losses based on changes in the ECL instead of the risk of a default occurring. The IASB rejected it for the reasons stated in the Basis for Conclusions (see paragraph 63 above).
67. While many agreed that the evaluation of a significant increase in credit risk should be based on the risk of a default occurring and not ECL, there were frequent suggestions to make the operation of the approach easier by further aligning it with credit risk management. This could be done by assessing a significant increase in credit risk based on changes in the 12-month probability of a default occurring, rather than based on changes in the lifetime probability of a

default occurring. Many of those participants were concerned that the proposals would require them to compare and prove that the outcome from a 12-month assessment would not differ from the outcome of a lifetime assessment. Some respondents requested for practical reasons, that they always be allowed to assess significant increases in credit risk based on changes in the 12-month probability of a default occurring.

68. Others requested clarification that the assessment should be based on the credit risk over the remaining life of the financial instrument and not just over the next 12 months after the reporting date. They were concerned that it might otherwise not result in the timely recognition of lifetime ECL on financial instruments that have terms resulting in ECL towards the end of the contractual term, such as for example financial instruments that require significant payments only at maturity (such as bullet loans).

Staff analysis

69. On the basis of the feedback above, most respondents agree with the proposal and agreed with the reasons for the proposal to consider only changes in the probability or risk of a default occurring rather than changes in ECL when assessing significant increases in credit risk.
70. The IASB has already discussed whether the increase in credit risk should be assessed on the basis of changes in the probability of a default occurring or based on changes in the amount of ECLs, noting that an assessment based on changes in the probability or risk of a default occurring would:
- (a) not capture situations in which the LGD of a financial instrument increases but the risk of a default occurring does not increase. (Even though economically the financial instrument could have the same ECL as other financial instruments with lifetime ECLs recognised).
- However the IASB noted that generally, despite the primacy given to the risk of a default occurring, the assessment of significant increases in credit risk would also incorporate an assessment about changes in LGD. This is because changes in LGD can indicate a change in the risk of a default (they are linked). In addition, the IASB noted that the change

in LGD is reflected in the 12-month ECL allowance balance (through the update of the ECL calculation); and

- (b) recognise lifetime ECL where there is a significant change in the risk of a default occurring but (in the extreme) little or no expected credit loss because of collateral. The IASB noted that this was acceptable because the recognition of lifetime ECL in this case would not result in inappropriate allowance balances being established. If the whole expected credit loss is recognised and it is de minimis then the impact would be de minimis⁶.

71. Respondents to our ED also made these observations . However, we did not receive any new information that the staff think warrants reopening or changing the proposal in the ED to focus on the changes in ECL rather than the risk of a default occurring.
72. The IASB is only being asked therefore whether, or in which circumstances, an entity shall use the lifetime or the 12-month probability of a default occurring to assess whether a significant increase in credit risk has occurred.
73. The application guidance in the ED already requires that an entity uses the lifetime probability of a default occurring when assessing whether the credit risk has increased significantly since initial recognition (see paragraph 63 above and B11 of the ED). However, the ED permits the use of a 12-month assessment *if the information considered does not suggest that the outcome would differ*.
74. Because the banks' credit risk management systems are geared towards a 12-month PD, some respondents suggested that the assessment of significant increases in credit risk should be based on the change in the 12-month PD. However, the staff note that there may be cases for which a 12-month assessment may not be appropriate, such as for example:
 - (a) for loans with back-ended payment profiles;
 - (b) when there are abnormal changes in macroeconomic or other credit-related factors occur that would indicate an abnormal shift in the risk curve; or

⁶ See Agenda Paper 5B of the December 2011 Joint Board meeting.

- (c) where changes in credit-related factors only have an impact on credit risk beyond the next 12 months.
75. In addition, the IASB proposed in the ED that lifetime expected credit losses shall be recognised when the entity suffers a significant economic loss from the financial instrument. An economic loss is assessed based on a change in the risk of a default occurring over the *life* of a financial instrument.
76. However, the 12-month probability of a default occurring is generally a reasonable approximation of the lifetime probability. Thus the assessment should generally be possible using the 12-month probability. The intention of the IASB was not to require entities to do both a 12-month and a lifetime assessment and to prove that the outcome would not differ.
77. To avoid having to prove that the outcome would not differ, the staff suggest:
- (a) clarifying paragraph B11 to make the simplification more useful in practice by permitting a 12-month assessment unless circumstances indicate that a lifetime assessment is necessary;
 - (b) providing examples of when a 12-month assessment would not be appropriate so that a lifetime assessment would be necessary, such as:
 - (i) for loans that only have significant payment obligations beyond the next 12 months (such as bullet loans or financial instruments that are non-amortising in the first few years);
 - (ii) when abnormal changes in macroeconomic or other credit-related factors occur that indicate an abnormal shift in the risk curve; or
 - (iii) changes in credit-related factors that only have an impact on credit risk (or where the impact is more pronounced) beyond 12 months.
78. The staff think that by changing the wording in the ED that permitted an assessment based on the change in the 12-month probability *if the information considered did not suggest that the outcome would differ*, we will remove the perception that entities have to prove that the outcome would not differ from an outcome based on the change in the lifetime probability. In addition, providing examples helps to illustrate what entities have to consider when determining

whether an assessment based on the change in the 12month probability is appropriate or instead an assessment based on changes in the lifetime probability is necessary.

79. **On the basis of the feedback and the analysis above, the staff recommend that the IASB should:**

- (a) **confirm that the assessment of when to recognise lifetime ECL should consider only changes in the probability or risk of a default occurring, rather than changes in the amount of ECLs (or credit loss given default (LGD)); and**
- (b) **clarify (in paragraph B11 of the ED) that an assessment based on the change in the 12-month probability or risk of a default occurring is permitted unless circumstances indicate that a lifetime assessment is necessary and to provide examples of when a 12-month assessment would not be appropriate/a lifetime assessment would be necessary,**

Question 3

Does the IASB agree with the staff recommendation as set out in paragraph 79?

Issue D: Should the model be symmetrical—ie should the 12-month allowance be re-established when credit risk has no longer increased significantly

80. The ED proposes that a loss allowance equal to 12-month ECL shall be re-established for financial instruments for which the criteria for the recognition of lifetime ECL are no longer met.
81. The Basis for Conclusions states:

[BC78] In the IASB's view, an entity should recognise favourable changes in credit quality that represent an economic gain consistently with unfavourable changes in credit quality, which represent an economic loss. ... In accordance with the general model, if financial instruments that had significantly deteriorated in credit quality since initial recognition subsequently improve in credit quality so that they no longer satisfy the lifetime expected credit loss criterion, then an entity should re-measure the loss allowance balance at an amount equal to 12-month expected credit losses with a resulting gain in profit or loss. Doing so would reflect the fact that the expectations of credit losses have moved back towards the initial expectations.

[BC79] In addition, to address concerns about potential earnings management, the IASB considered requiring a higher credit quality for the change back to a loss allowance balance at an amount that is equal to 12 month expected credit losses than the credit quality that is required by the criteria for the recognition of lifetime expected credit losses. The IASB rejected such a requirement because it reduces the usefulness, neutrality and faithful representation of expected credit losses, which it should not override for anti-abuse considerations. The IASB also noted that such arbitrary distinctions can have unintended consequences, such as creating a disincentive to recognise lifetime expected credit losses because of the

higher hurdle to change back to the recognition of 12 month expected credit losses.

82. The IASB asked the following question in the ED:

Question 5

(e) Do you agree with the proposal that the model shall allow the re-establishment of a loss allowance (or provision) at an amount equal to 12-month expected credit losses if the criteria for the recognition of lifetime expected credit losses are no longer met? If not, why not, and what would you prefer?

Staff analysis and recommendation

83. Nearly all respondents agreed with the proposal that a loss allowance at an amount equal to 12-month ECL should be re-established if the criteria for the recognition of lifetime ECL are no longer met. They noted that this proposal would be consistent with the objective of a deterioration model and would faithfully represent the underlying economics.

84. **The staff recommend that the IASB confirm the proposal that a loss allowance measured at an amount equal to 12-month ECL shall be re-established for financial instruments for which the criteria for the recognition of lifetime ECL are no longer met.**

Question 4

Does the IASB agree with the staff recommendation to confirm the proposal that a loss allowance measured at an amount equal to 12-month ECL shall be re-established for financial instruments for which the criteria for the recognition of lifetime ECL are no longer met?

Appendix A

A1. The ED proposes the following application guidance about the information to consider when assessing whether the recognition of lifetime ECL is required:

[B20] When determining whether the recognition of lifetime expected credit losses is required, an entity shall consider the best information available that might affect the credit risk of the financial instrument in accordance with paragraphs 17(b) and B5–B8. Consideration of the following may assist the entity when making that determination:

- (a) significant changes in external market indicators of credit risk for a particular financial instrument or similar financial instruments with the same term. Changes in market indicators of credit risk include, but are not limited to:
 - (i) the credit spread;
 - (ii) the credit default swap prices for the borrower;
 - (iii) the length of time and extent to which the fair value of a financial asset has been less than its amortised cost; and
 - (iv) other market information related to the borrower, such as changes in the price of a borrower's debt and equity instruments;
- (b) an actual or expected significant change in the financial instrument's external credit rating;
- (c) significant changes in internal price indicators of credit risk as a result of a change in credit quality since inception, including, but not limited to, the credit spread that would result if a particular financial instrument or similar financial instrument with the same terms and the same counterparty were newly originated or issued at the reporting date;
- (d) other changes in the rates or terms of an existing financial instrument that would be significantly different if the instrument

was newly originated or issued at the reporting date (such as more stringent covenants, increased amounts of collateral or guarantees, or higher income coverage) because of changes in the credit risk of the financial instrument since initial recognition;

- (e) an actual or expected internal credit rating downgrade for the borrower or decrease in behavioural scoring used to assess credit risk internally. Internal credit ratings and internal behavioural scoring are more reliable when they are mapped to external ratings or supported by default studies;
- (f) existing or forecast adverse changes in business, financial or economic conditions that are expected to cause a significant change in a borrower's ability to meet its debt obligations, such as an actual or expected increase in interest rates or an actual or expected significant increase in unemployment rates;
- (g) significant changes in operating results of the borrower. Examples include actual or expected declining revenues or margins, increasing operating risks, working capital deficiencies, decreasing asset quality, increased balance sheet leverage, liquidity, management problems or changes in the scope of business or organisational structure (such as the discontinuance of a segment of the business) that results in a significant change in a borrower's ability to meet its debt obligations;
- (h) a significant credit deterioration on other financial instruments of the same borrower;
- (i) an actual or expected significant adverse change in the regulatory, economic, or technological environment of the borrower that results in a significant change in the borrower's ability to meet its debt obligations, such as a decline in the demand for the borrower's sales product because of a shift in technology;
- (j) significant changes in the value of the collateral supporting the obligation and the quality of third-party guarantees or credit enhancements, which are expected to reduce the borrower's economic incentive to make scheduled contractual payments or to otherwise have an effect on the probability of a default

occurring. For example, if the value of collateral declines because house prices decline, borrowers in some jurisdictions have a greater incentive to default on their mortgages;

- (k) a significant change in the quality of the guarantee provided by a 100 per cent shareholder (or an individual's parents) if the shareholder (or parents) have an incentive and financial ability to prevent default by capital or cash infusion;
- (l) significant changes, such as reductions in financial support from a parent entity or other affiliate or an actual or expected significant change in the quality of credit enhancement, which are expected to reduce the borrower's economic incentive to make scheduled contractual payments. Credit quality enhancements or support include the consideration of the financial condition of the guarantor and/or, for interests issued in securitisations, whether subordinated interests are expected to be capable of absorbing expected credit losses (for example, on the loans underlying the security);
- (m) expected changes in the loan documentation including an expected breach of contract that may lead to covenant waivers or amendments, interest payment holidays, interest rate step-ups, requiring additional collateral or guarantees, or other changes to the contractual framework of the instrument;
- (n) significant changes in the expected performance and behaviour of the borrower, including changes in the payment status of borrowers in the group (for example, an increase in the expected number or extent of delayed contractual payments or a significant increase in the expected number of credit card borrowers who are expected to approach or exceed their credit limit or who are expected to be paying the minimum monthly amount);
- (o) changes in the entity's credit management approach in relation to the financial instrument, ie based on emerging indicators of changes in credit quality of the financial instrument, the entity's credit risk management practice is expected to become more active or focused on managing the instrument, including an

instrument becoming more closely monitored or controlled, or the entity specifically intervening with the borrower; and

- (p) past-due information as set out in paragraph 9.