

STAFF PAPER

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Project	Financial Instruments: Impairment		
Paper topic	Operational simplifications – 30dpd and <i>low credit risk</i>		
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Purpose of the paper

1. The Exposure Draft *Financial Instruments: Expected Credit Losses* ('the Exposure Draft') proposed that an entity should recognise lifetime expected credit losses (ECL) when the credit risk on a financial instrument has increased significantly since initial recognition. The assessment of significant increases in credit risk should take into account the probability/risk of a default occurring over the remaining life of the instrument.
2. To assist entities in evaluating whether lifetime ECL should be recognised, the Exposure Draft proposed two operational simplifications. In this paper we discuss the feedback we received and how these two simplifications could be potentially clarified. The simplifications were:
 - (a) a rebuttable presumption that the credit risk on a financial instrument has significantly increased over its remaining life when contractual payments are more than 30 days past due (dpd); and
 - (b) that there have not been significant increases in the credit risk of a financial instrument if a financial instrument has a *low credit risk* at the reporting date.
3. We do not discuss in this paper:

- (a) the interaction between the low credit risk notion and the measurement of financial instruments at fair value through other comprehensive income (FVOCI) (see paragraph 37); and
- (b) the interaction between the low credit risk notion and the transition requirements. This will be discussed at a future meeting.

Structure of the paper

4. The paper is set out as follows:

- (a) More than 30 days past due rebuttable presumption:
 - (i) background (paragraphs 15 - 18);
 - (ii) detailed feedback received (paragraph 19 - 23); and
 - (iii) staff analysis and recommendation (paragraphs 24-29).
- (b) Low credit risk exception:
 - (i) background (paragraphs 30 - 32);
 - (ii) detailed feedback received (paragraphs 33 - 40); and
 - (iii) staff analysis and recommendation (paragraphs 41-66):
 - 1. clarifying the meaning of low credit risk (paragraphs 43-57); and
 - 2. nature of the exception (paragraphs 58-66).
- (c) Appendices A–B.

Summary of feedback and staff recommendations

5. As mentioned in paragraph 2, the proposals in the Exposure Draft included two operational simplifications to assist in determining whether there has been a significant increase in credit risk.

More than 30 days past due rebuttable presumption

6. The majority of respondents supported the inclusion of a rebuttable presumption based on a delinquency factor. Respondents stated that this would be helpful

when other borrower-specific or forward-looking information is not available to identify significant increases in credit risk before delinquency occurs.

7. However, some respondents did not agree with the threshold being more than 30 dpd and felt that instead the delinquency factor should be more than 60 dpd (or even 90 dpd). Other respondents believed that in clarifying the objective of the presumption, concerns with consistent application could be addressed.
8. During our fieldwork some participants observed significant increases in credit risk over the remaining life of the instrument when payments were more than 30 dpd.
9. **We recommend that the IASB retain the rebuttable presumption, but in addition clarify:**
 - (a) **that the objective of the rebuttable presumption is to serve as a backstop identifying those instruments that have experienced a significant increase in credit risk;**
 - (b) **that it is meant to result in recognition of lifetime ECL before there is objective evidence of impairment; and**
 - (c) **that an entity can rebut this presumption where it has reasonable and supportable information that more than 30 dpd is not the point at which a significant increase in credit risk arises.**

Low credit risk exception

10. Respondents had mixed views on the inclusion of the *low credit risk* exception, with no clear preferences amongst any interested party groups.
11. Those that supported this proposal argued that it *increases the operability* of the proposals, especially for investments in high quality financial instruments.
12. However, those respondents that opposed the exemption noted that it was unclear what was meant by *low credit risk*, and what the interaction is between that and investment grade ratings. They commented that in their view even within the investment grade ratings, instruments experience significant increases in credit risk. Conflicting views were given on the effect of this exception on the

operability of the proposals, so respondents had differing views on whether the exception should be a requirement or an accounting policy choice.

13. Respondents noted some areas where clarifications were needed, in particular the use of the term ‘investment grade’ as an example of what is meant by *low credit risk*.
14. **Based on the feedback received, we recommend that the IASB:**
- (a) **allows an entity to select, as an accounting policy choice, whether to apply the *low credit risk* exemption per class of financial assets or not; and**
 - (b) **in the consideration of *low credit risk*:**
 - (i) **modifies the description of *low credit risk*;**
 - (ii) **clarifies that there is not a bright-line (hair trigger) distinction between instruments regarded as *low credit risk* and those that are not; and**
 - (iii) **clarifies that reference to ‘investment grade’:**
 - 1. **does not mean that only externally rated instruments qualify as *low credit risk*; and**
 - 2. **requires an entity to consider global rating scales, instead of national (domestic) rating scales to determine if an instrument is *low credit risk*.**

More than 30 days past due rebuttable presumption

Background

15. The Exposure Draft proposed that entities should apply more forward-looking information rather than *only* past due information (ie delinquencies) to assess whether there have been significant increases in credit risk since initial recognition. The IASB confirmed this objective at their September meeting¹.

¹ Agenda Paper 5A *Responsiveness of the general model*

16. However, the IASB acknowledged that entities do not always have borrower-specific information available that is more forward-looking than past due status. The IASB believed that:
- (a) generally, significant increases in credit risk happen before default or objective evidence of impairment (see paragraph B12 of the Exposure Draft); and
 - (b) it did not want the threshold for significant increases in credit risk to revert to the incurred loss notion of IAS 39 *Financial Instruments: Recognition and Measurement* (see paragraph BC75 of the Exposure Draft).
17. Accordingly, to assist entities to assess whether lifetime ECL should be recognised, the Exposure Draft proposed a rebuttable presumption that the credit risk on a financial instrument has significantly increased, over its remaining life, when the contractual payments are more than 30 dpd.
18. This presumption can be rebutted when an entity has information available that demonstrates that even if contractual payments become more than 30 dpd, it does not represent a significant increase in the credit risk of a financial instrument. For example, if:
- (a) non-payment was an administrative oversight, instead of resulting from financial difficulty of the borrower; or
 - (b) an entity has evidence that demonstrates that, based on historic information and trends, there is no correlation between customers that become 30dpd and those that eventually do default.

Detailed feedback received

Comment letters

19. The majority of respondents consider the presumption based on a delinquency factor to be helpful, particularly when entities do not have other borrower-specific or forward-looking information available that enables them to identify significant increases in credit risk prior to delinquency. Those that supported the rebuttable presumption noted that:

- (a) the outcome is broadly in line with existing credit risk management practices (ie looking at delinquency information) and is therefore a good indication of increases in credit risk over the remaining life of a financial instrument;
- (b) it achieves an appropriate balance between faithfully reporting significant increases in credit risk and the cost of tracking and assessing those increases in credit risk; and
- (c) because past due status is a lagging indicator, it would not be appropriate to have a longer delinquency period as the rebuttable presumption. One comment letter observed that when financial instruments are more than 30 dpd the probability of default occurring in the next 12 months significantly increases (sometimes exceeding a 50 per cent probability of default within the next year).

20. The respondents that did not support the rebuttable presumption can be divided into two groups.

- (a) those that argued that there should not be any past due indicator, because it creates a bright-line for the assessment of significant increases in credit risk. They argued that delinquency is a lagging indicator that fails to identify significant increases in credit risk on a timely basis. They were concerned that preparers will rely on the rebuttable presumption in isolation, without incorporating more forward-looking information even when such information is available. This could result in the delayed recognition of lifetime ECL².
- (b) others argued that the rebuttable presumption should be later than 30 dpd (for example 60 dpd or 90 dpd). They argued that:
 - (i) 30 dpd does not always indicate significant increases in credit risk and could result in volatility in the amount of ECLs recognised. The volatility would arise if financial

² Refer to Agenda Paper 5A *Responsiveness of the general model* from the September 2013 IASB meeting in which this matter was discussed.

instruments are quickly transferred to Stage 2 and transferred back to Stage 1 when the borrower pays the outstanding payments; and/or

- (ii) regulators should be allowed to decide what past due indicator would be appropriate in their jurisdiction.

21. Respondents also had different views on the presumption being rebuttable:

- (a) those that supported the presumption agreed that it should be rebuttable. They argued that a past due status of 30 days would not be appropriate for all types of products and jurisdictions, therefore it needs to be rebuttable in those cases;
- (b) those that did not support the presumption had mixed views on it being rebuttable. Some felt it would be operationally onerous, because the entity would need to rebut the presumption on an instrument-by-instrument basis, Others however felt that that it could be easily rebutted because an entity could simply state that for credit risk management purposes they apply a different threshold.

22. Supporters of the proposals suggested additional clarifications to ensure that the principle is applied consistently:

- (a) to clearly articulate the objective of the rebuttable presumption;
- (b) to make clear that the more than 30 dpd threshold is not a bright-line trigger to recognise lifetime ECL and it can therefore not be applied in isolation; and
- (c) to indicate (perhaps through illustrative examples) when it would be, or would not be, appropriate to rebut the presumption.

Fieldwork

23. During the fieldwork, some participants assessed whether the rebuttable presumption will correlate to significant increases in credit risk. They observed that when an instrument became more than 30dpd, there was a corresponding

increase in the lifetime probability of default ranging between a 160% increase on some products to over 1000% on other products³.

Staff analysis and recommendation

24. Delinquency information is a lagging indicator of increases in credit risk. Consequently, if past-due status is permitted as an indicator that credit risk has increased significantly it should lead to earlier rather than later recognition of lifetime ECL (ie 30 dpd rather than 60 dpd). This is consistent with the view in paragraph BC75 of the Exposure Draft which states:

Ideally, and consistently with the forward-looking nature of expected credit losses, an entity should use forward-looking information, such as the price for credit risk, probabilities of default occurring and internal or external credit ratings, when assessing whether it should recognise lifetime expected credit losses. However, many entities manage credit risk on the basis of information about past-due status and have a limited ability to assess credit quality on an instrument-by-instrument basis in more detail. Thus, the IASB decided that an entity may consider information about past-due status, together with other, more forward-looking information, in its assessment of the deterioration in credit quality, if appropriate. To supplement the deterioration requirement, and to ensure that the criterion does not revert to an incurred loss notion, the recognition of lifetime expected credit losses shall be met if an asset is more than 30 days past due and no other borrower-specific information that is forward-looking is available.

25. Furthermore, the majority of fieldwork participants and respondents to the Exposure Draft supported the rebuttable presumption as an appropriate indicator of significant increases in credit risk over the remaining life of a financial instrument.

³ We note that the results would vary depending on the type of product and jurisdiction.

26. We note that the intention was that as a result of the rebuttable presumption, lifetime ECL should typically be recognised no later than when a financial instrument is 30 dpd. However, we note that the rebuttable presumption was not meant to be a bright-line indicator of significant increases in credit risk across all products or jurisdictions. It serves as a backstop to start recognising lifetime ECL when it is not possible to use other, more forward-looking information (including macro-economic factors on a portfolio level). It certainly was not intended to prevent financial instruments being considered to have significantly increased credit risk before they are 30 dpd. In doing so, it makes the proposals more operable because it would:
- (a) serve as a benchmark for entities that do not have sophisticated credit risk management systems; or for those products or regions where borrower-specific information is not available; and
 - (b) enable entities to leverage the information they are currently using and not require them to undertake an exhaustive search for new information. A key consideration in the Exposure Draft was to use information that could be obtained without undue cost or effort (this was also acknowledged in Agenda Paper 5A of the September joint board meeting).
27. We have also noted that the need to recognise lifetime ECLs based on other considerations was already addressed at the September 2013 meeting in Agenda Paper 5A *Financial Instruments: Responsiveness of the general model*.

Staff recommendation

28. We are of the view that it is still appropriate, subject to clarifications, to **retain the rebuttable presumption as proposed in the Exposure Draft** for the reasons set out in this section.
29. We recommend the following **clarifications** to resolve some of the operational concerns:
- (a) to note that the objective of the rebuttable presumption is to serve as the backstop identifying those instruments that have experienced a significant increase in credit risk. Accordingly an

entity should recognise lifetime ECL on these instruments if that has not already occurred, ie, generally we believe that instruments where contractual payments are more than 30dpd have experienced significant increases in credit risk. However, as indicated, it is a backstop, and accordingly we are of the view that an entity should identify significant increases in credit risk before this backstop. To better reflect this objective, we recommend to alter the proposal to clarify that:

there is a rebuttable presumption that there has been a significant increase in credit risk on an instrument when contractual payments are more than 30dpd, unless the entity has reasonable and supportable information to support a more lagging delinquency criterion. It is not necessary to rebut the presumption where assessment of significant increase is made before instrument is more than 30dpd the instrument

- (b) it is intended that the application of the rebuttable presumption should identify significant increases in credit risk *before* default or objective evidence of impairment. Consequently, to note that it would *not* be appropriate to align the timing of recognising lifetime ECL to what is normally considered as the actual occurrence of default or objective evidence of impairment; and
- (c) rebutting the presumption would not require an instrument-by-instrument assessment. The presumption could be rebutted if an entity has information that indicates that for a particular product, region or borrower-type, more than 30 dpd is not representative of the point at which credit risk significantly increases.

Questions to the IASB

Does the IASB agree to keep the rebuttable presumption that there was a significant increase in credit risk when contractual payments are more than 30 days past due?

Does the IASB agree with the clarifications as listed in paragraph 29?

Low credit risk exception

Background

30. The Exposure Draft proposed to measure an allowance (or provision) for financial instruments that have a *low credit risk* at the reporting date, at an amount equal to 12-month ECL, without an assessment of whether there have been significant increases in credit risk.
31. The IASB believed that the proposed exception would increase the operability of the proposed model for the following reasons:

BC76 The IASB has included an exception for financial instruments with low credit risk at the reporting date. Irrespective of their change in credit risk, an entity shall not recognise lifetime expected credit losses on those financial instruments. The IASB introduced this exception to reduce the operational costs for entities that apply the model and to make the model more cost-effective. The IASB observed that for financial instruments with low credit risk the effect of this exception on the timing of recognition and the amount of expected credit losses would be minimal, even when considering that the recognition of lifetime expected credit losses would occur later than it would if there was no exception. Thus, the tracking of credit quality and the assessment of deterioration in credit quality is limited to financial instruments whose credit risk low enough that adverse economic conditions or changes in business or financial circumstances could, at most, lead to the inability to fully recover cash flows in the medium or short term. Such credit risk is typically equivalent to the investment grade market convention, ie an entity need not assess financial instruments with financial instruments with credit risk that is equivalent to investment grade for deterioration in credit quality. In the IASB's view, such an exception would help to achieve an appropriate balance between the benefits of distinguishing between financial instruments on the basis of credit quality and the costs of making that

distinction. The IASB also noted that financial instruments of such a quality were not the primary focus for the recognition of lifetime expected credit losses...

BC208 In order to reduce operational burden of tracking the probability of a default occurring for all financial instruments since initial recognition, this Exposure Draft does not require an entity to recognise lifetime expected credit losses on financial instruments with low credit risk at a reporting date (irrespective of their change in credit risk). Consequently, an entity will not need to assess the change in credit quality from initial recognition for financial instruments that have a low credit risk on a reporting date (eg financial instruments whose credit risk is equivalent to investment grade).

32. As stated in paragraph BC76, the IASB believed that for financial instruments with low credit risk the effect of this exception on the timing of recognition and the amount of lifetime ECL would be minimal, even when considering that the recognition of lifetime ECL would occur later than if there was no exception. The IASB also noted that these high quality instruments were not the primary focus for the recognition of lifetime ECL.

Detailed feedback received

Comment letters

33. Respondents had mixed views on the inclusion of the *low credit risk* exception and there were no clear preferences among the various constituent groups. Most respondents supported the exemption, but suggested a number of clarifications regarding the meaning of low credit risk and the application thereof.
34. The respondents that supported the proposals said that:
- (a) it reduces the costs of implementation by eliminating the need to assess whether increases in credit risk were significant for high quality financial instruments, which was particularly beneficial when the majority of an entity's investments are in high quality instruments. This point was particularly raised by insurance

entities that often invest only in high quality debt securities and do not have sophisticated credit risk management systems to track changes in credit risk since initial recognition.

- (b) that it would not be appropriate to recognise lifetime ECL on high credit quality instruments.

35. Those respondents that did not support the proposals argued that :

- (a) there is no clear notion of *low credit risk* and that this lack of clarity would result in diversity in practice.
- (b) even if instruments are *low credit risk* (for example ‘investment grade’ rated instruments), in their view downgrades within this grade could represent significant increases in credit risk. The proposed exception may result in a delay in recognising the effects of such increases. To support their argument, these respondents referred to historical default rates on what would be regarded as investment grade instruments (refer to Appendix B).
- (c) it does not reduce the operability concerns. Some argued that complexity is actually introduced on two levels:
 - (i) firstly, the assessment of what is *low credit risk* which could be very subjective; and
 - (ii) secondly, it requires additional system modifications to differentiate between financial instruments that are low credit risk and those that are not in order to determine the population of assets for which increases in credit risk should be assessed.

36. None of the respondents that disagreed with the inclusion of the low credit risk exemption stated that they did so because they considered low credit risk to be an inappropriate threshold. They did so because of operability concerns, (see paragraph 35(c)), and suggested permitting an entity to make an accounting policy choice about whether the low credit risk exception will be applied or not.

37. A few respondents, particularly insurers, suggested introducing a practical expedient for debt instruments measured at FVOCI that are *low credit risk*. We

intend to consider the application of the impairment model to FVOCI debt instruments at a future meeting⁴.

38. Additionally, respondents raised a number of questions about the meaning of *low credit risk* that need to be clarified in order to ensure consistent application. These can be summarised as follows:

- (a) concerns about the description of *low credit risk* and the interpretation of the words in the Exposure Draft.
- (b) whether a move below *low credit risk* is a bright-line and an automatic trigger to recognise lifetime ECL (ie that lifetime ECL must be recognised on a financial instrument that is low credit risk on reporting date when it ceases to be low credit risk irrespective of whether there has been a significant increase in credit risk).
- (c) how the reference to ‘investment grade’ should be interpreted. Respondents specifically asked for clarification on whether it refers to:
 - (i) only instruments that are externally rated as ‘investment grade’; and
 - (ii) global scale or national scale (domestic) rating grades.

Fieldwork

39. During the fieldwork some participants had considered how they could apply this *low credit risk* exception and some raised concerns similar to those outlines in paragraphs 35(c), 36 and 38(c).

40. Others operationalised the proposals by mapping their internal probabilities of defaults (PDs) to externally rated ‘investment grade’ PDs. These participants then applied the *low credit risk* exception to their relevant internally rated products.

⁴ This assumes that the FVOCI category will be confirmed in the Classification and Measurement redeliberations. This decision is outstanding at the time of writing this paper.

Staff analysis and recommendation

41. As none of the respondents disagreed with *low credit risk* being the appropriate threshold for the exemption, we are *not* asking the IASB to reconsider that. Instead, our analysis considers whether the proposed exemption should be retained subject to clarification.
42. We believe that before considering whether to retain the proposed exemption for *low credit risk*, it is important to first consider potential clarifications to the proposed exception.

The meaning of 'low credit risk'

43. The Exposure Draft defined low credit risk as follows:

6 ...credit risk is low if default is not imminent and any adverse economic conditions or changing circumstances may lead to, at most, a weakened capacity of the borrower to meet its contractual cash flows obligations on the financial instrument. For example, a loan that has an internal credit risk rating equivalent to external credit rating 'investment grade' would be considered to have a low risk.
44. As mentioned in paragraph 38, respondents identified certain clarifications they believed would be helpful in ensuring more consistent application of the *low credit risk* exemption.

Objective of the low credit risk exception

45. In introducing the exception, the IASB argued that as long as an instrument has low credit risk the effect on the timing and recognition of lifetime ECL for these instruments would be minimal even if the change in credit risk was deemed to be significant (see paragraph BC76 of the Exposure Draft).
46. We believe the objective of this exemption was therefore to provide operational relief for high quality financial instruments. These instruments have, compared to other instruments, a low risk of default and investors typically consider these types of instruments as safe investments from a credit perspective.

Description of low credit risk

47. Respondents identified some areas of concern with regards to the proposed description of low credit (see paragraph 43) noting the following contradictory terms in the proposed wording:
- (a) the use of the words ‘default is not imminent’ could lead to the conclusion that even very low credit quality instruments are exempt from the need to be considered for significant increases in credit risk, ie delaying recognition of full lifetime ECL; and
 - (b) the use of ‘any adverse economic conditions’ could lead to the conclusion that most financial instruments would fail to be considered low risk. This is because extreme scenarios always exist that could result in even the best quality instruments defaulting.
48. To assist in the understanding of what the market considers *low credit risk* we included Appendix B to this paper that provides an overview of the external credit ratings. Based on these descriptions, the proposed definition included in the Exposure Draft and the feedback from respondents, we believe that the following are key characteristics of instruments with a *low credit risk*:
- (a) these instruments have a low risk of default.
 - (b) the lender considers the borrower to have a strong capacity, in particular in the near term, to meet its financial obligations. For higher credit quality (eg AAA/Aaa), the borrower would also be expected to have a strong capacity in the longer term to settle obligations.
 - (c) the lender expects that in the longer term, changes in economic and business conditions *may*, but does not necessarily, reduce the ability of the borrower to meet its obligations.

Absolute bright-line

49. A number of respondents noted that it was unclear whether the *low credit risk* notion was intended as a bright-line that would automatically trigger the recognition of lifetime ECL, ie as soon as financial instruments that are low credit risk on initial recognition deteriorate to below *low credit risk*, an entity should

recognise lifetime ECL regardless of whether there is a significant increase in credit risk.

50. We are of the view that this was not the intention of the IASB. Instead, paragraph 6 of the Exposure Draft provides relief from assessing whether increases in credit risk have been significant for as long as the instrument is deemed *low credit risk*. Accordingly, where an instrument was originated as *low credit risk* and subsequently deteriorates to below *low credit risk*, an entity should assess the extent of increases in credit risk and lifetime ECL should be recognised only when there have been significant increases in credit risk (ie the model would apply in the normal way).
51. This view is consistent with the basis of the proposed deterioration model, ie the recognition of lifetime ECL when there have been significant increases in credit risk.

Interaction with investment grade

52. To illustrate the proposed meaning of *low credit risk*, the Exposure Draft referred to an instrument with an external ‘investment grade’ rating (see paragraph 43 for an extract) as an illustration of an instrument with a *low credit risk*. An overview of the application of ‘investment grade’ and external credit ratings are provided in Appendix B to this paper. In summary, the term ‘investment grade’ is a market convention to identify those financial instruments that the market considers to have low (sometimes moderate) credit risk compared to other instruments in a market. It is also important to remember that credit ratings are not exact measures of the probability of a default occurring, but rather expresses the risk of default relative to other rated instruments.

External vs. internal rating grades

53. We believe the intention with the reference to ‘investment grade’ did *not* imply that only those instruments that are externally rated by a credit rating agency would qualify for the low credit risk exception. We believe that instruments that are not externally rated may still qualify for the *low credit risk* exemption. It was only intended to provide an indication of the level of credit risk that the IASB intended.

Example of mapping

Bank Z has a portfolio of corporate loans with an average life of seven years. Bank Z determined the lifetime probability of default to be 0,9%. After taking into account relevant adjustments (for example liquidity adjustments), Bank Z compares this to a similar externally rated securitised product with a 7-year life. Bank Z concludes that the corporate loan portfolio is equivalent to the external rating grades between A and BBB(Baa). Accordingly, Bank Z concludes that the corporate loan portfolio can be deemed as low credit risk.

Global vs. national rating scales

54. Many respondents requested clarification about whether the low credit risk notion refers to global or national scale ratings. To illustrate how such ratings compare we looked at two recent press articles:

SANRAL (South African Roads Agency)

Moody's recently announced its rating of SANRAL as Baa3 (global scale, local and foreign currency) and A3.za (South African national scale).

When considering the national scale ratings, SANRAL is rated as being strong relative to other South African debt issuers. However, when considering the global scale ratings, it is not so strong although it would still be considered 'investment grade'.

Fibria (Brazilian pulp and paper company)

Moody's recently announced its rating of Fibria as a Ba1 (global rating scale) and Aa2.br (Brazil national scale rating) as a debt issuer.

Using a national scale rating, a lender may conclude that this is *low credit risk*, however, when considering global scale rating, the lender would consider it speculative as the global rating is non investment grade.

55. We believe the intention of the *low credit risk* notion was to be a safe harbour for globally accepted high quality instruments. Furthermore we are of the view that if the assessment was to be done using national scale ratings, the objective of the exemption may not be achieved (see paragraph 45 – 46) as instruments on a national scale may not internationally represent high quality, safe harbour investments. This would result in a real lack of comparability in application of the model globally.

56. For this reason, we also recommend clarifying that the notion of low credit risk does not refer to an entity's assessment of low credit risk in the context of the risk appetite of the business. For example, some lenders' target market is high risk individuals or businesses. For those lenders, often their highest credit quality customers will be considered high risk customers by other market participants even if the lenders themselves consider them to be low credit risk relatively speaking.

Staff recommendation

57. In clarifying the meaning and application of the low credit risk notion, we recommend the following clarifications be made to the proposed requirements:
- (a) clarify that the objective of the *low credit risk* notion is to provide operational relief for high quality financial instruments, in other words, those with a low risk of default and that investors typically consider as safe investments from a credit risk perspective.
 - (b) modify the proposed description of *low credit risk* to better reflect the characteristics of *low credit risk*, namely that:
 - (i) the instrument has a low risk of default;
 - (ii) that the borrower is considered, in the near term, having a strong capacity to meet its obligations; and
 - (iii) the lender expects in the longer term that adverse changes in economic and business conditions may, but does not necessarily, reduce the ability of the borrower to fulfil its obligations.
 - (c) clarify that the *low credit risk* notion is not meant to be a bright-line trigger for the recognition of lifetime ECL. Instead, when an instrument is no longer deemed to be *low credit risk*, an entity would assess the extent of increases in credit risk to determine whether lifetime ECL should be recognised.
 - (d) clarify that the requirements for financial instruments to be deemed *low credit risk* instruments:
 - (i) do not require instruments to be externally rated; but

- (ii) continue to use an investment grade rating as an example but to clarify that financial instruments should have a level of credit risk comparable to global credit ratings of investment grade, instead of national scale ratings.

Question to the IASB

Does the IASB agree to clarify that the objective of the *low credit risk* notion is to provide operational relief for high quality financial instruments, in other words, those with a low risk of default and that investors typically consider as safe investments from a credit risk perspective?

Does the IASB agree with the clarification as listed in paragraph 57?

Nature of the low credit risk exception

58. As evidenced from the feedback received, respondents had mixed views about whether the low credit risk exception should be a requirement or an accounting policy choice.
59. We observed that the responses from both those that supported and those that did not support the proposal were driven from an operational perspective. As discussed in paragraph 34(a) those respondents that supported the proposal included insurers that have less sophisticated credit risk management systems to assess significant increases in credit risk. In addition, they often invest only in high quality instruments. Consequently, the low credit risk exception assists those entities to implement the proposals by reducing the operational burden of assessing increases in credit risk since initial recognition.
60. At the other end of the spectrum are those preparers (mainly banks) that would have to modify their existing credit risk management systems to enable them to implement the proposals. For those preparers the proposed exception adds another layer of complexity to the proposed model by including an additional threshold to be assessed. For example, if they set up processes to identify significant increases in credit risk on all financial instruments they may conclude that there is a significant increase in risk on a financial instrument that is low credit risk—they thus need to be able to separate those financial instruments out to

apply the proposals. Some of those preparers would prefer to only apply the general model without the *low credit risk* exemption.

61. We have identified three possible alternatives for the IASB to consider about when and if the low credit risk exemption would apply:

(a) **Alternative 1: retain the proposals in the Exposure Draft.**

Under this alternative an entity will be required to measure the allowance on all financial instruments regarded as *low credit risk* as 12-month ECL (ie Stage 1). This alternative would result in comparability between entities because all instruments that are globally accepted as *low credit risk* would be in Stage 1. The intention of introducing this exemption was to reduce operability concerns. However, the feedback received indicated that for some entities, this alternative will actually increase the operational burden for some by adding another threshold consider when determining whether lifetime ECL should be recognised.

(b) **Alternative 2: remove the exemption for *low credit risk*.** Under this alternative, all financial instruments would be assessed for significant increases in credit risk in the same way. This alternative would also result in comparability between entities because lifetime ECL would be recognised on all financial instruments for which credit risk has increased significantly regardless of the credit quality at initial recognition. However, this would require entities that generally invest only in high quality instruments and that may not have sophisticated credit risk management systems or credit risk information to incur costs to implement new credit risk management systems applicable to all of their financial instruments in the scope of the impairment model. This would be at odds with the reasons for introducing the exemption originally.

(c) **Alternative 3: Accounting policy choice.** Under this approach, an entity should make an accounting policy choice about applying the low credit risk exception. This alternative will achieve operational simplification for both groups of respondents, but it would also

reduce comparability between entities. However, allowing an accounting policy choice for the application of the low credit risk exception will be consistent with the reasons for the accounting policy choice permitted for trade receivables with a significant financing component and for lease receivables. This is set out in paragraph BC143 of the Exposure Draft:

...The IASB noted that allowing this option for trade receivables and lease receivables would reduce comparability. However, it would alleviate some of the practical concerns of tracking credit deterioration for entities that do not have sophisticated credit risk management systems. ...In the IASB's view, the benefits of achieving comparability do not outweigh the costs to implement the full model in this case.

Furthermore, as noted in paragraph BC76, the effect of the exception on the timing of the recognition and amount of ECL would be minimal. There would only be a difference for those low credit risk financial assets that have experienced a significant increase in credit risk. This is expected to be a small population. Consequently, the difference between financial asset classes for which the accounting policy is applied and other asset classes is expected to be minimal.

62. Based on the feedback received which indicated that requiring the low credit risk exception to be applied only results in operational simplification for some respondents while increasing the operational burden for others, we are not recommending Alternative 1. However, for the same reasons, we are not recommending Alternative 2, as this will increase the operational burden for those entities that do not have sophisticated credit risk management systems and that wanted to apply the low credit risk exception.
63. **We recommend Alternative 3.** We consider it to be the most appropriate alternative as this will allow entities to decide whether to apply the low credit risk exception based on their credit risk management systems.

Level at which accounting policy election should be made

64. In permitting an accounting policy choice, we believe that it is also important to consider the level at which this accounting policy choice should be made. We have identified the following approaches:

- (a) **Instrument-by-instrument:** this approach would require an entity to exercise the accounting policy on an instrument-by-instrument basis, ie individual transactions for the same or similar assets. We **do not** recommend this approach because this would require the accounting policy to be applied at a level that requires too much detail and is onerous. We do not consider applying an accounting policy choice at such a level to provide relevant and useful information to users of financial statements. Furthermore, as the proposed exemption was intended as an operational simplification, an application at such a detailed level may cancel out any operational relief provided by the exemption.
- (b) **Portfolio level:** for financial reporting purposes, the term ‘portfolio’ is used in a variety of ways and can describe groups of similar assets (for example mortgages) as well as different types of financial instruments managed together to achieve a common objective (for example liquidity portfolio). Although different types of financial instruments may be managed together to achieve a common objective, the risk characteristics and credit risk management practices for each type of financial instrument in the portfolio may be different. We therefore **do not** recommend this approach because applying an accounting policy to financial instruments with different risk characteristics will not achieve the objectives of the proposed model. Furthermore, this approach would require additional guidance to be developed in order to be operable.
- (c) **Level at which significant increases in credit risk are assessed:** this approach would align the application of the accounting policy choice with the level at which the entity assesses significant

increases in credit risk, ie collective or individual assessment.

Although the Exposure Draft proposed that the assessment of significant increases in credit risk could be performed on a collective (portfolio) level if financial instruments share the same risk characteristics, the composition of the group being assessed collectively would change if the risk characteristics of some instruments in the group change. This approach will therefore give rise to the same concerns and operational challenges as discussed in (a) and (b). For those reasons, we **do not** recommend this approach.

- (d) **Reporting entity level:** under this approach the accounting policy decision will be made at a reporting entity level. In other words, an entity would either apply the low credit risk exemption to all its financial instruments (subject to meeting the criteria) or not at all, based on its cost-benefit analysis. The benefit of this approach is that it provides operational simplification to those entities that supported the exemption (ie insurers) without increasing the complexity for those entities that did not support it. We consider this a **viable** approach for the IASB to consider.
- (e) **Classes of financial instruments:** the Exposure Draft requires the proposed disclosures to be provided by class of financial instrument similar to the requirements of IFRS 7 *Financial Instruments: Disclosures*. IFRS 7 describes a class of financial instrument as being a group that is appropriate to the nature of the information disclosed and takes into account characteristics of those instruments⁵. The benefit of this approach is that the application of the accounting policy choice will be consistent with the level of detail that entities already disclose. It will therefore allow an entity to select the classes for financial instruments to which the proposed exemption is applied, without requiring it to be applied to all financial instruments thereby providing the

⁵ IFRS7 paragraphs 6 and B1-B3

operational simplification that the proposed exemption was intended for. We **recommend** this as our preferred approach.

65. We note additionally that in making the accounting policy election, it does not in itself mean that the financial instruments to which the accounting policy will apply are low credit risk. An entity would still need to determine which financial instruments satisfy the description of low credit risk as set out in paragraph 57 above. It simply means that if the exemption election is made, lifetime ECL need not be recognised on instruments that are low credit risk at a reporting date without further analysing changes in credit risk. For example, an entity would still need to map its internal credit ratings to external credit ratings as discussed in paragraphs 52 - 56 in order to satisfy the criteria in paragraph 57(b).
66. We recommend that an entity elects an accounting policy per class of financial instrument (paragraph 64(e)).

Questions to the IASB

1. Does the IASB agree that an entity should elect as an accounting policy whether to apply the exemption for low credit risk when assessing whether there has been a significant increase in credit risk on an instrument (ie Alternative 3)?
2. Does the IASB agree that an entity should make this election at the 'class of asset' level (as per paragraph 64(e))?

Appendix A

Extract from Appendix C in Agenda Paper 5B *Criteria for recognition of lifetime expected losses of November 2012*

A1. S&P notes that BBB is generally regarded as the lowest investment grade by market participants.

Global Corporate Average Cumulative Default Rates (1981-2011)															
--Time horizon (years)--															
(%)	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
AAA	0	0.03	0.14	0.25	0.37	0.49	0.55	0.64	0.71	0.78	0.81	0.85	0.89	0.97	1.06
AA	0.02	0.07	0.14	0.26	0.37	0.49	0.6	0.69	0.77	0.86	0.94	1.01	1.09	1.17	1.23
A	0.08	0.18	0.32	0.48	0.66	0.86	1.1	1.31	1.53	1.77	1.97	2.14	2.3	2.45	2.66
BBB	0.24	0.67	1.13	1.71	2.3	2.88	3.38	3.88	4.38	4.88	5.41	5.85	6.3	6.76	7.22
BB	0.9	2.7	4.8	6.8	8.61	10.34	11.85	13.21	14.49	15.59	16.49	17.29	17.97	18.55	19.24
B	4.48	9.95	14.57	18.15	20.83	23	24.76	26.19	27.46	28.7	29.77	30.65	31.47	32.22	33.01
CCC/C	26.82	35.84	41.14	44.27	46.72	47.82	48.79	49.66	50.77	51.65	52.42	53.28	54.24	55.13	55.13

S&P Data and Charts (source: Standard and Poors 2011 Annual Global Corporate Default Study And Rating Transitions)

A2. Opponents to the operational exemption of *low credit risk* noted:

...probabilities of default vary significantly for longer maturities as one moves towards the lower end of the investment grade range (BBB as compared AAA) (4). For example, the cumulative probabilities of default is said to vary between 0% and 1.06% for AAA instruments and 0.24% and 7.22% for BBB instruments over a 1-year to a 15-year time horizon.

Appendix B

Understanding credit ratings and ‘Investment grade products’

- A3. Credit ratings are not absolute measures of the probability of default on financial instruments. Instead, it is an opinion, usually by a credit rating agency, about the relative ability of the entity to meet the contractual obligations under the contract. Standard and Poor’s Rating services describes it as follows⁶:

Credit ratings are forward-looking opinions about credit risk. Standard & Poor’s credit ratings express the agency’s opinion about the ability and willingness of an issuer, such as a corporation or state or city government, to meet its financial obligations in full and on time.

Credit ratings can also speak to the credit quality of an individual debt issue, such as a corporate note, a municipal bond or a mortgage-backed security, and the relative likelihood that the issue may default.

Since there are future events and developments that cannot be foreseen, the assignment of credit ratings is not an exact science. For this reason, Standard & Poor’s ratings opinions are not intended as guarantees of credit quality or as exact measures of the probability that a particular issuer or particular debt issue will default.

Instead, ratings express relative opinions about the creditworthiness of an issuer or credit quality of an individual debt issue, from strongest to weakest, within a universe of credit risk. The likelihood of default is the single most important factor in our assessment of creditworthiness.

For example, a corporate bond that is rated ‘AA’ is viewed by Standard & Poor’s as having a higher credit quality than a corporate bond with a ‘BBB’ rating. But the ‘AA’ rating isn’t a guarantee that it will not default, only that, in our opinion, it is less likely to default than the ‘BBB’ bond.

- A4. The rating agencies do not use the term investment grade in their internal rating systems. Fitch Ratings notes:

⁶ <http://www.standardandpoors.com/ratings/definitions-and-faqs/en/us>

The terms "investment grade" and "speculative grade" have established themselves over time ... The terms "investment grade" and "speculative grade" are market conventions, and do not imply any recommendation or endorsement of a specific security for investment purposes. "Investment grade" categories indicate relatively low to moderate credit risk, while ratings in the "speculative" categories either signal a higher level of credit risk or that a default has already occurred.

A5. The table summarises the definitions from the 3 major rating agencies for their different credit quality ratings and also indicates what level market participants would consider investment grade:

S&P	Moody's	Fitch
Investment grade would usually refer to categories AAA to BBB (with BBB- being lowest investment grade considered by market participants)	Investment grade would usually refer to categories Aaa to Baa (with Baa3 being lowest investment grade considered by market participants)	Investment grade would usually refer to categories AAA to BBB (with BBB- being lowest investment grade considered by market participants)
<p>AAA</p> <p>Extremely strong capacity to meet financial commitments. Highest Rating.</p>	<p>Aaa</p> <p>Obligations rated Aaa are judged to be of the highest quality, subject to the lowest level of credit risk.</p>	<p>AAA: Highest credit quality</p> <p>Denotes the lowest expectation of default risk. They are assigned only in cases of exceptionally strong capacity for payment of financial commitments. This capacity is highly unlikely to be adversely affected by foreseeable events.</p>
<p>AA</p> <p>Very strong capacity to meet financial commitments.</p>	<p>Aa</p> <p>Obligations rated Aa are judged to be of high quality and are subject to very low credit risk.</p>	<p>AA: Very high credit quality</p> <p>Denotes expectations of very low default risk. They indicate very strong capacity for payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.</p>

S&P	Moody's	Fitch
<p>A</p> <p>Strong capacity to meet financial commitments, but somewhat susceptible to adverse economic conditions and changes in circumstances.</p>	<p>A</p> <p>Obligations rated A are judged to be upper-medium grade and are subject to low credit risk.</p>	<p>A: High credit quality</p> <p>Denotes expectations of low default risk. The capacity for payment of financial commitments is considered strong. This capacity may, nevertheless, be more vulnerable to adverse business or economic conditions than is the case for higher ratings.</p>
<p>BBB</p> <p>Adequate capacity to meet financial commitments, but more subject to adverse economic conditions.</p>	<p>Baa</p> <p>Obligations rated Baa are judged to be medium-grade and subject to moderate credit risk and as such may possess certain speculative characteristics.</p>	<p>BBB: Good credit quality</p> <p>Indicates that expectations of default risk are currently low. The capacity for payment of financial commitments is considered adequate but adverse business or economic conditions are more likely to impair this capacity.</p>

Distinction line between investment grade and speculative grade

<p>BB</p> <p>Less vulnerable in the near-term but faces major on-going uncertainties to adverse business, financial and economic conditions.</p>	<p>Ba</p> <p>Obligations rated Ba are judged to be speculative and are subject to substantial credit risk</p>	<p>BB: Speculative</p> <p>Indicates an elevated vulnerability to default risk, particularly in the event of adverse changes in business or economic conditions over time; however, business or financial flexibility exists which supports the servicing of financial commitments.</p>
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National scale ratings

A6. National scale ratings are given in certain jurisdictions. Instead of indicating the credit quality on a global level, a national rating expresses the credit quality

relative to the lowest credit risk in the country, normally being government debt. Because these ratings are not intended to be internationally comparable, they are denoted with an identifier, usually at the end of the rating, eg for South Africa the identifier will be.za and for Brazil.br.

- A7. National ratings are generally for countries whose sovereign ratings are not high credit quality (eg not 'AAA/Aaa') and even sometimes below 'investment grade' (global scale). These ratings were introduced to countries where the global rating scale provided inadequate differentiation due to limited use of global credit ratings. If for example the best credit quality in the country is BBB/Baa, then all ratings AAA/Aaa to A would not be available in that country. This reduces differentiation between these instruments.