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Project	Financial Instruments: Impairment
Paper topic	Overview of tentative expected credit loss impairment model

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Introduction

1. The purpose of this paper is to provide an overview of the tentative expected credit loss (ECL) impairment model. This overview incorporates the proposals in the Exposure Draft *Expected Credit Losses* (the 2013 ED) and the tentative decisions made during the redeliberation process.

2. This paper if for discussion only and does not include any questions to the IASB.

Scope of the tentative ECL model

3. The tentative ECL impairment model applies to:

    (a) financial assets that are measured at amortised cost;

    (b) financial assets that are mandatorily measured at fair value through other comprehensive income (FVOCI);

    (c) loan commitments when there is a present contractual obligation to extend credit and that are not measured at fair value through profit or loss (FVPL);

    (d) financial guarantee contracts to which IFRS 9 is applied and that are not measured at FVPL; and

    (e) lease receivables and trade receivables.

Overview of the tentative ECL model

4.   The tentative ECL model is a single impairment model that aims to provide users of financial statements with more useful information about an entity's expected credit losses and can graphically be summarised as follows:
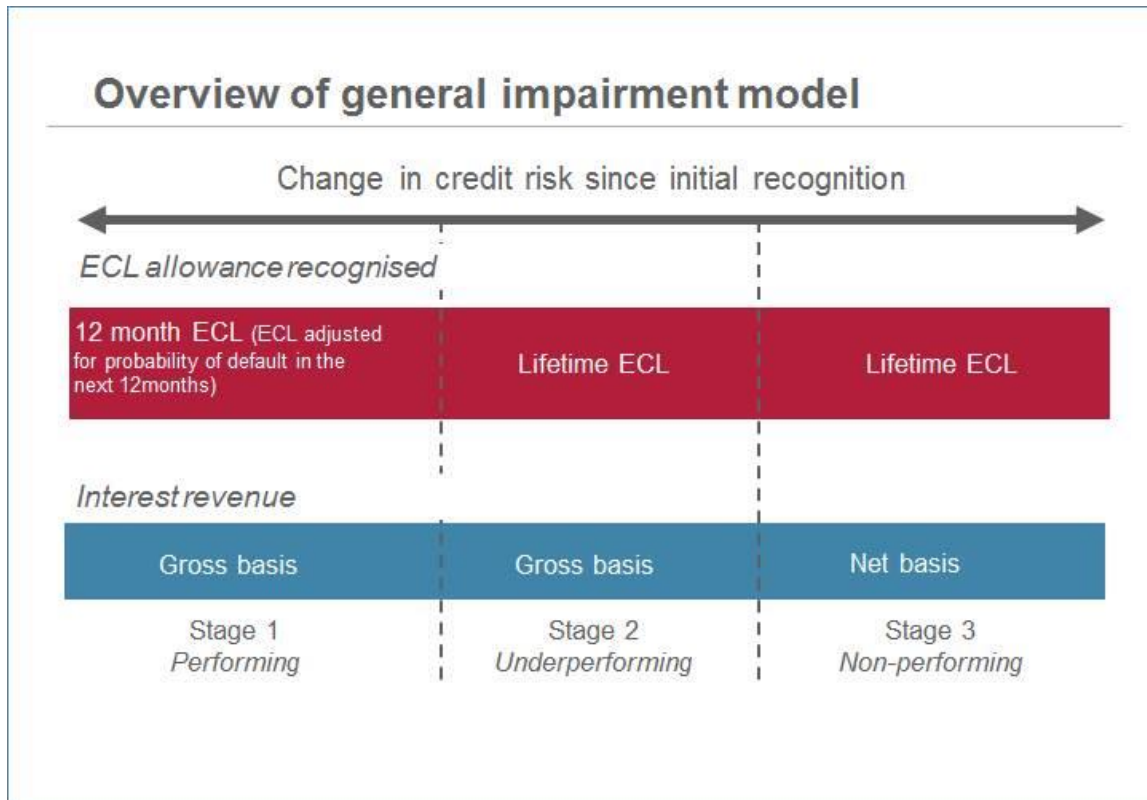
5.   For all financial instruments in the scope of the tentative ECL model (other than those that are credit-impaired on initial recognition), an entity shall recognise, **at each reporting date**:

     (a)   lifetime ECL (ECL resulting from default events over the life of the instrument) for financial instruments if there has been a significant increase in credit risk since initial recognition (Stages 2 and 3); and

     (b)   12-month ECL (ECL resulting from default events within the next 12 months) for all other financial instruments (Stage 1).

6.   An entity would generally present and calculate interest revenue using the effective interest method on the gross carrying amount. However, the way in which that interest revenue is calculated and presented changes if there is objective evidence of impairment (Stage 3). An entity would then present and

calculate interest revenue using the effective interest method on the net carrying amount (ie the gross carrying amount less allowance for the ECL).

Recognition of ECL

7. Most financial instruments would generally have a 12-month ECL allowance on origination or purchase. This stage would capture at the reporting date those instruments that have not significantly increased in credit risk since initial recognition.

8. The 12-month ECL are a portion of the lifetime ECL and represent the amount of expected credit losses that would result from a default in the 12 months after the reporting date. The losses are therefore *not:*

    (a)   lifetime ECL that an entity will incur on financial instruments that it predicts will default in the next 12 months; or

    (b)   the cash shortfalls that are predicted over the next 12 months.

9. At each reporting period the entity would remeasure the 12-month ECL (ie update the 12-month expected loss allowance) for financial instruments that have not had a significant increase in credit risk since initial recognition, to reflect the entity's current expectations about expected credit losses.

10. Lifetime ECL should be recognised when credit risk has increased significantly since initial recognition.

11. A loss allowance measured at an amount equal to 12-month expected credit losses shall be re-established for financial instruments for which the criteria for the recognition of lifetime expected credit losses are no longer met

Assessing significant deterioration

12. An entity shall assess whether there has been a significant increase in credit risk by comparing the:

    (a)   credit risk at the reporting date; to

    (b)   the credit risk at initial recognition of the financial instrument.

13. In assessing credit risk, the entity should consider only changes in the risk of a default occurring over the remaining maturity of the financial instrument, rather than changes in the amount (ie severity) of ECL (or the credit loss given default (LGD)).

14. The tentative model does not prescribe a particular method to assess increases in credit risk. An entity could perform the assessment for financial instruments that have shared credit risk characteristics.

15. The objective of the tentative model is to recognise lifetime expected credit losses on *all* financial instruments for which there has been a significant increase in credit risk—whether on an individual or portfolio basis—and that all reasonable and supportable information, including forward-looking information that is available without undue cost or effort needs to be considered.

16. Examples of ways in which the assessment of significant increases in credit risk could be implemented more simply, include:

    (a) establishing the initial maximum credit risk for a particular portfolio (by product type and/or region) (the 'origination' credit risk) and comparing that to the credit risk at the reporting date. This would only be possible for portfolios of financial instruments with similar credit risk on initial recognition;

    (b) assessing increases in credit risk through a counterparty assessment as long as such assessment achieves the objectives of the proposed model;

    (c) assessing the change in the risk of a default occurring in the next 12 months unless circumstances indicate that a lifetime assessment is necessary.

17. Generally, a financial instrument would have a significant increase in credit risk before there is objective evidence of impairment or before default occurs.

Operational simplifications

18. The tentative ECL model includes two operational simplifications to assist entities in assessing significant increases in credit risk.

Low credit risk

19. The simplification is intended to reduce the operational burden of assessing significant increases in credit risk for high quality investments

20. The loss allowance for financial instruments that are deemed to be 'low credit risk' at the reporting date (for example, a loan that has an internal credit risk rating equivalent to the external credit rating of 'investment grade'), would continue to be recognised at 12-month ECL.

21. A financial instruments is deemed to be low credit risk when:

    (a)   it has a low risk of default;

    (b)   the borrower is considered, in the near term, to have a strong capacity to meet its obligations; and

    (c)   the lender expects for the longer term that adverse changes in economic and business conditions may, but not necessarily, reduce the ability of the borrower to fulfil its obligations.

22. Financial instruments are not required to be externally rated; but should equate to a global credit rating definition of 'investment grade'.

23. The low credit risk simplification is not meant to be a bright-line trigger for the recognition of lifetime expected credit losses. Instead, when an instrument is no longer low credit risk, an entity should assess whether there has been a significant increase in credit risk to determine whether lifetime expected credit losses should be recognised.

More than 30 days past due

24. There is a rebuttable presumption that there have been significant increases in credit risk when contractual payments are more than 30 days past due. However, information that is more forward-looking than past due information will typically be available and should be considered in determining whether there has been a significant increase in credit risk at the reporting date.

25. The objective of the rebuttable presumption is to serve as a backstop or latest point at which to identify financial instruments that have experienced a significant

increase in credit risk. It therefore aims to identify significant increases in credit risk before default or objective evidence of impairment occur.

Measurement of the ECL

26.   The ECL is the *present value* of the expected cash shortfalls over the life of the financial instrument.

27.   The tentative ECL model does not prescribe a method to measure the ECL. However, an entity's estimate of expected losses should reflect:

   (a)   the best available information including information about past events, current conditions and reasonable and supportable forecasts of future events and economic conditions at the reporting date;

   (b)   an unbiased and probability-weighted estimate of cash flows associated with a range of possible outcomes; and

   (c)   the time value of money.

28.   To estimate the ECL and the changes in credit risk, an entity shall consider information that is reasonably available, including information about past events, current conditions and reasonable and supportable forecasts of future events and economic conditions. The degree of judgement that is required for the estimates depends on the availability of detailed information.

29.   For periods beyond 'reasonable and supportable forecasts' an entity should consider how best to reflect its expectations by considering information at the reporting date about the current conditions, as well as forecasts of future events and economic conditions.

30.   As the forecast horizon increases, the availability of detailed information decreases and the degree of judgement to estimate ECL increases. The estimate of ECL does not require a detailed estimate for periods that are far in the future— for such periods, an entity may extrapolate projections from available, detailed information.

31.   An entity shall apply a default definition that is consistent with credit risk management practices and take into consideration qualitative indicators of default

when appropriate (such as for financial instruments that contain covenants). There is a rebuttable presumption that default does not occur later than 90 days past due unless an entity has reasonable and supportable information to support a more lagging default definition.

32.   ECL should be discounted at the effective interest rate or an approximation thereof.

33.   Regulatory ECL models may form a basis for ECL calculations but the measurement may need to be adjusted to meet the objectives of the proposed model.

Uncollectablity/Write-off

34.   An entity should consider a financial asset to be uncollectable if the entity has no reasonable expectation of recovery. Consequently, an entity should write-off a financial asset, or part of a financial asset, in the period in which the entity has no reasonable expectation of recovery of the financial asset (or part of the financial asset).

35.   A write-off requires the entity to directly reduce the gross carrying amount of a financial asset resulting from uncollectability. A write-off constitutes a derecognition event.

Loan commitments and financial guarantee contracts

36.   An entity should recognise a liability (ie provision) for ECL on loan commitments and financial guarantee contracts.

37.   When estimating the ECL of loan commitments and financial guarantee contracts, other than revolving credit facilities, an entity should consider the remaining contractual period, or shorter period, over which it is exposed to credit risk.

38.   For revolving credit facilities ECL, including those on the undrawn commitment, should be estimated for the period over which an entity is exposed to credit risk and future drawdowns cannot be avoided.

39.   ECL should be discounted using the same effective interest rate, or an approximation thereof, used to discount ECL on the drawn balance, unless the effective interest rate cannot be determined, in which case the discount rate should be determined by reference to the current risk free rate and the risks reflected in the cash flows.

40.   The provision for ECL on a loan commitment should be presented together with the loss allowance for the associated financial asset if an entity cannot separately identify the ECL associated with the loan commitment.

Modified financial assets

41.   Modified financial assets (that do not result in derecognition) should be considered in the same way as other (non-modified) assets within the model.

42.   When an entity evaluates significant increases in credit risk, the entity should compare the credit risk at the reporting date (based on the modified contractual terms) to the credit risk at initial recognition (based on the original contractual terms).

43.   The gross carrying amount should be recalculated on the basis of the modified contractual cash flows discounted at the original EIR and a modification gain or loss should be recognised in profit or loss.

Purchased or originated credit impaired financial assets

44.   When there is objective evidence of impairment as a result of one or more events that occurred on or before the initial recognition of an financial asset, an entity should:

   (a)   include lifetime expected credit losses in the estimated cash flows when computing the effective interest rate on initial recognition (ie a credit-adjusted effective interest rate); and

   (b)   recognise subsequent changes in lifetime expected credit losses in profit or loss.

45.   This treatment is similar to the accounting treatment of purchased credit-impaired financial assets in paragraph AG5 of IAS 39 *Financial Instruments: Recognition and Measurement.*

46.   An entity should present and calculate interest revenue using the effective interest method on the amortised cost (ie net carrying amount, or gross carrying amount less allowance for the ECL) of those financial instruments.

Simplified approach for trade and lease receivables

47.   The requirements of the tentative ECL model relating to trade receivables and lease receivables interact with the Revenue Recognition and Leases projects.

48.   Operational simplifications are included for those financial instruments, because they are often held by entities that do not have sophisticated credit risk management systems. This would provide relief by eliminating the need to calculate 12-month ECL and to assess when a significant increase in credit risk has occurred.

Trade receivables with a significant financing component

49.   An entity has an accounting policy choice to apply the simplified approach to measure the loss allowance at an amount equal to lifetime ECL at initial recognition and throughout the trade receivables' life.

Trade receivables without a significant financing component

50.   For trade receivables that do not have a significant financing component, the loss allowance should be measured at an amount equal to lifetime ECL at initial recognition and throughout the trade receivables' life. As a practical expedient, a provision matrix could be used to estimate ECL for these trade receivables.

51.   An entity should measure trade receivables that do not have a significant financing component (in accordance with the forthcoming new Standard on Revenue) at the transaction price on initial recognition. In many cases this would be the invoice amount.

Lease receivables

52. For lease receivables, an entity could make an accounting policy election to apply the simplified approach to measure the loss allowance at an amount equal to lifetime ECL at initial recognition and throughout the asset's life.

53. The simplified approach aims to reduce complexity in practice, because an entity would not need to identify increases in credit risk. The cash flows used in the measurement of the lease receivables would be used as the contractual cash flows when assessing the lease receivables' expected credit loss allowance. When selecting the discount rate to be used, the upper limit of the permissible range is the discount rate used in the measurement of the lease receivable.

Presentation

54. An entity should present in the statement of profit or loss and other comprehensive income separate line items for the following amounts:

    (a) interest revenue, calculated using the effective interest method and applying the effective interest rate to the gross carrying amount unless paragraph 55 applies; and

    (b) gains and losses resulting from changes in the ECL.

55. An entity calculates interest revenue using the effective interest method on the amortised cost (ie net carrying amount, or gross carrying amount less loss allowance) if:

    (a) at the reporting date, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset; or

    (b) the asset was purchased or originated credit-impaired on initial recognition (and in this case a credit-adjusted EIR is used).

Disclosure

56.   The disclosure objectives are to disclose:

(a)   the amount of the ECL that arises in the financial statements; and

(b)   the effect of changes in credit risk of financial instruments that are within the scope of the proposals.

57.   To meet this objective, an entity should disclose:

(a)   reconciliation of gross carrying amounts and allowance balances;

(b)   disclosures on credit risk grading; and

(c)   disclosures on techniques, assumptions and policies (for example, write-off policy).

Transition

58.   The tentative ECL model should be applied retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting estimates and Errors.*

59.   An entity should use the credit risk at initial recognition for existing financial assets when initially applying the tentative ECL model (ie to determine whether there has been a significant increase in credit risk), unless obtaining such credit quality information requires undue cost or effort.

60.   An entity may apply the low credit risk simplification to identify financial instruments for which the credit risk has not significantly increased.

61.   An entity could approximate the credit risk on initial recognition by considering the best available information that is available without undue cost or effort. The best available information is information that is:

(a)   reasonably available and does not require the entity to undertake an exhaustive search for information; and

(b)   relevant in determining or approximating the credit risk at initial recognition.

62.   When approximating the credit risk on initial recognition, an entity could

(a)   apply the rebuttable presumption for contractual payments that are more than 30 days past due, if the entity identifies increases in credit risk according to days past due; or

(b)   compare the credit risk at the date of transition to the initial maximum credit risk that is accepted for a particular portfolio (by product type and/or region).

63.   If an entity is not able to determine or approximate the credit risk on initial recognition, it should measure the loss allowance based on the credit quality at each reporting date until the financial instrument is derecognised.

64.   Restatement of comparative periods are not required, but permitted if the information is available without the use of hindsight. In addition, the disclosures in paragraph 28(f) of IAS 8 would be permitted, but not required, for prior periods if the information is available without the use of hindsight.

65.   On the date of initial application of IFRS 9 the entity should disclose a reconciliation of the ending impairment allowances under IAS 39 and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* to the opening impairment allowances under IFRS 9 by measurement category, showing separately the effect of reclassifications on the allowance balance at that date.