STAFF PAPER

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Project	**Transition Resource Group for Impairment of Financial Instruments**
Paper topic	The maximum period to consider when measuring expected credit losses

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Introduction

1. This paper addresses a question raised by a submitter regarding the appropriate period to consider when measuring Expected Credit Losses ('ECL') in accordance with IFRS 9 *Financial Instruments* (2014). In this paper, the staff:
   (a) set out the accounting requirements in IFRS 9 pertinent to this issue;
   (b) identify the potential implementation issue raised by the submitter; and
   (c) ask the members of the Transition Resource Group for Impairment of Financial Instruments ('ITG') for their views on the issue identified.

Background

2. The submitter presents an example of a portfolio of mortgage loans that are managed on a collective basis and on which individual credit reviews are not undertaken. A contractual feature of these loans is that the term is automatically extended, unless the lender objects. The submitter asks what is the appropriate

period to consider when measuring ECL in respect of loans in this portfolio in accordance with paragraph 5.5.19 of IFRS 9.

Accounting requirements

3. Paragraph 5.5.19 of IFRS 9 provides the following requirements regarding the maximum period to consider when measuring ECL:

> The maximum period to consider when measuring expected credit losses is the maximum contractual period (including extension options) over which the entity is exposed to credit risk and not a longer period, even if that longer period is consistent with business practice.

4. As discussed in paragraphs BC5.254–BC5.261 of IFRS 9, the IASB considered concerns raised by respondents on the 2013 Impairment Exposure Draft in relation to the period to be considered for measuring expected credit losses for specific financial instruments. These respondents noted that there were certain financial instruments that included both a loan and an undrawn commitment component and for which the entity's contractual ability to demand repayment, and cancel the undrawn commitment, did not limit the entity's exposure to credit losses to the contractual notice period. In these cases, both the drawn and undrawn balance are managed together from a credit risk perspective and lenders generally tended to extend credit for a duration longer than the contractual minimum and only withdraw the facility if observable credit risk on the facility had increased significantly. Consequently, restricting the recognition of ECL to the contractual notice period would not reflect the underlying economics or the way in which these facilities were managed.

5. Having considered these concerns, the IASB reaffirmed its decision to use the maximum contractual period over which the entity is exposed to credit risk as the maximum period to consider when measuring ECL. Nevertheless, in acknowledgement of the situation above and as discussed in paragraphs BC5.260

and BC5.261 of IFRS 9, the IASB decided to include an exception to this principle in very specific cases:

> The IASB remains of the view that the contractual period over which an entity is committed to provide credit (or a shorter period considering prepayments) is the correct conceptual outcome. The IASB noted that most loan commitments will expire at a specified date, and if an entity decides to renew or extend its commitment to extend credit, it will be a new instrument for which the entity has the opportunity to revise the terms and conditions. Consequently, the IASB decided to confirm that the maximum period over which expected credit losses for loan commitments and financial guarantee contracts are estimated is the contractual period over which the entity is committed to provide credit.
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> However, to address the concerns raised about the financial instruments noted in paragraphs BC5.254–BC5.257, the IASB decided that for financial instruments that include both a loan and an undrawn commitment component and the entity's contractual ability to demand repayment and cancel the undrawn commitment does not limit the entity's exposure to credit losses to the contractual notice period, an entity shall estimate expected credit losses over the period that the entity is expected to be exposed to credit risk and expected credit losses would not be mitigated by credit risk management actions, even if that period extends beyond the maximum contractual period. When determining the period over which the entity is exposed to credit risk on the financial instrument, the entity should consider factors such as relevant historical information and experience on similar financial instruments. The measurement of expected credit losses should take into account credit risk management actions that are taken once an exposure has increased in credit risk, such as the reduction or withdrawal of undrawn limits.

6. Consequently, paragraph 5.5.20 of IFRS 9 includes the following exception (emphasis added):

> However, some financial instruments include both a loan and an undrawn commitment component and the entity's contractual ability to demand repayment and cancel the undrawn commitment does not limit the entity's exposure to credit losses to the contractual notice period. *For such financial instruments, and only those financial instruments,* the entity shall measure expected credit losses over the period that the entity is exposed to credit risk and expected credit losses would not be mitigated by credit risk management actions, even if that period extends beyond the maximum contractual period.

7. Paragraphs B5.5.39 and B5.5.40 of IFRS 9 also provide the following related application guidance:

> However, in accordance with paragraph 5.5.20, some financial instruments include both a loan and an undrawn commitment component and the entity's contractual ability to demand repayment and cancel the undrawn commitment does not limit the entity's exposure to credit losses to the contractual notice period. For example, revolving credit facilities, such as credit cards and overdraft facilities, can be contractually withdrawn by the lender with as little as one day's notice. However, in practice lenders continue to extend credit for a longer period and may only withdraw the facility after the credit risk of the borrower increases, which could be too late to prevent some or all of the expected credit losses. These financial instruments generally have the following characteristics as a result of the nature of the financial instrument, the way in which the financial instruments are managed, and the nature of the available information about significant increases in credit risk:

(a) the financial instruments do not have a fixed term or repayment structure and usually have a short contractual cancellation period (for example, one day);

(b) the contractual ability to cancel the contract is not enforced in the normal day-to-day management of the financial instrument and the contract may only be cancelled when the entity becomes aware of an increase in credit risk at the facility level; and

(c) the financial instruments are managed on a collective basis.

When determining the period over which the entity is expected to be exposed to credit risk, but for which expected credit losses would not be mitigated by the entity's normal credit risk management actions, an entity should consider factors such as historical information and experience about:

(a) the period over which the entity was exposed to credit risk on similar financial instruments;

(b) the length of time for related defaults to occur on similar financial instruments following a significant increase in credit risk; and

(c) the credit risk management actions that an entity expects to take once the credit risk on the financial instrument has increased, such as the reduction or removal of undrawn limits.

8. The above requirements illustrates that paragraph 5.5.19 of IFRS 9 limits the period to consider when measuring ECL to the maximum contractual period in all cases with only one exception as set out in paragraph 5.5.20 of IFRS 9.

Potential implementation issue identified

9. Consider the following example:

Bank A manages a portfolio of variable rate mortgages on a collective basis. The mortgage loans are issued to retail customers in Country X with the following terms:

- the stated maturity is 6 months with an automatic extension feature whereby, unless the borrower or lender take action to terminate the loan at the stated maturity date, the loan automatically extends for the following 6 months;
- the interest rate is fixed for each 6-month period at the beginning of the period. The interest rate is reset to the current market interest rate on the extension date; and
- the lenders right to refuse an extension is unrestricted.

It is assumed that the mortgage loans meet the criteria for amortised cost measurement under paragraph 4.1.2 of IFRS 9.

In practice, borrowers are generally expected not to elect to terminate their loans on the stated maturity date, because moving the mortgage to another bank, or applying for a new product, generally involves an administrative burden and has little or no economic benefit for the borrower.

Furthermore, Bank A does not complete regular credit file reviews for individual loans and as a result does not usually cancel the loans unless it receives information about an adverse credit event in respect of a particular borrower. On the basis of historical evidence, such loans extend many times—and can last for up to 30 years.

Question:

1. What is the maximum period Bank A should consider when measuring expected credit losses under IFRS 9, if the contractual extension option is subject to lender's non-objection?

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10. The submitter firstly considers how the requirements in paragraph 5.5.19 of IFRS 9 should be applied to this example and why the exception outlined in paragraph 5.5.20 of IFRS 9 should not apply. However, having completed this analysis, the submitter raises a question as to whether in this specific case, the lack of practical ability for the lender to exercise their option to prevent extension on a timely basis could be considered to extend the period of exposure to credit risk beyond the maximum contractual period.

11. In considering the appropriate application of paragraphs 5.5.19 and 5.5.20 of IFRS 9, the submitter makes the following points:

    (a) paragraphs 5.5.19 of IFRS 9 states that the maximum period to consider when measuring expected credit losses is the maximum contractual period (including extension options) over which the entity is exposed to credit risk and not a longer period, even if that longer period is consistent with business practice. Consequently, the fact that these loans have historically been extended without the contractual commitment to do so cannot be considered in determining this period;

    (b) the extension options referred to in paragraph 5.5.19 of IFRS 9 should be interpreted as referring to borrower options, because lender extension options cannot be considered to create credit exposure. This is because the lender can unilaterally choose not to extend the loan. Furthermore, if the extension options were interpreted to include lender options to extend, then the exception provided by paragraph 5.5.20 of IFRS 9 would not be needed, because lenders have an option to extend facilities for credit cards and other revolving facilities.

    (c) the exception set out in paragraph 5.5.20 of IFRS 9, which permits the maximum contractual period to be extended beyond the contractual period of commitment, cannot be applied either directly or by analogy to this example because:

(i) it only applies to financial instruments that include both a loan and an undrawn commitment component; and

(ii) paragraphs BC260 and 261 of IFRS 9 explain that the IASB intended this to be a narrow exemption that applied to a defined population. It would therefore not be appropriate to analogise to this exception on the basis that the lender does not have specific information to withdraw the loan until it receives information about an adverse credit event for the borrower.

12. Based on the above analysis, the submitter concludes that the maximum period to consider when measuring ECL in accordance with paragraph 5.5.19 of IFRS 9 should be the remaining period to the stated maturity of 6 months because after this date Bank A is contractually entitled to prevent the loan from being extended.

13. However, the submitter goes on to point out that in this particular example, the contractual right of Bank A to prevent an extension of the loan is not exercised unless information about an adverse credit event in respect of a particular borrower has been received. This is because the portfolio is managed on a collective basis and Bank A does not complete regular credit file reviews for individual loans.

14. Consequently, the submitter questions whether in this case, the period that Bank A should consider when measuring ECL should be a period in excess of 6 months, such as the historically observed behavioural life. In this regard, the submitter makes the following points:

(a) paragraph 5.5.19 of IFRS 9 requires extension options to be considered and does not specify whether these should be lender or borrower options—consequently, the lender extension option which is a contractual feature of this loan, should be considered (as should a lenders option to demand early repayment, which is no different in substance).

(b) if the period beyond 6 months is not considered, then expected credit losses will not reflect the way in which credit risk is managed and the actual credit exposure of the lender. As a result, expected credit losses could be understated because the probability of default and the calculation of potential shortfalls in contractual cash flows will consider a period significantly shorter than the historically observed behavioural life of these instruments. Furthermore, there would be practical challenges in terms of how Bank A should derive the appropriate probability of default and estimate potential shortfalls based on a contractual requirement to repay that Bank A does not expect will exist in 6 months.

15. As regards the argument put forward by the submitter in paragraph 14(b), the staff would refer to the accounting requirements outlined in paragraph 5. This highlights that the IASB redeliberated on the subject of the appropriate period to consider when measuring ECL and that the outcome of those redeliberations was a reaffirmation that using the maximum contractual period over which the entity is exposed to credit risk was the conceptually correct outcome and that the only exception was as set out in paragraph 5.5.20.

Question for the members of ITG
What are your views on the issue presented above?