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STAFF PAPER

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Project	**Transition Resource Group for Impairment of Financial Instruments**		
Paper topic	Measurement of expected credit losses in respect of a modified financial asset		
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Introduction

1. This paper addresses a question raised by a submitter regarding the measurement of Expected Credit Losses ('ECL') in respect of a financial asset where the contractual cash flows have been modified but the modification has not resulted in the financial asset being derecognised. In this paper, the staff:

   (a) set out the accounting requirements in IFRS 9 *Financial Instruments* (2014) pertinent to this issue along with the relevant presentation and disclosure requirements prescribed by IAS 1 *Presentation of Financial Statements* and IFRS 7 *Financial Instruments: Disclosures*; and

   (b) ask the members of the Transition Resource Group for Impairment of Financial Instruments ('ITG') for their views on the questions raised.

Background

2. Example 11 of IFRS 9 illustrates how an entity should account for the modification of a financial asset when the modification does not result in derecognition. It also addresses the subsequent measurement of ECL on such a modified financial asset.

3. The submitter points out that in that example, the ECL allowance increases after modification, but in many instances this will not be the case, because such a renegotiation will often serve to reduce the contractual cash flows to a level that is consistent with the lender's expectation of what the borrower can repay. The submitter asks whether in such situations the ECL allowance should be reduced to nil. The submitter also asks what the appropriate presentation and disclosure requirements are that should apply to such a modified financial asset.

Accounting requirements

4. Paragraph 5.4.3 of IFRS 9 provides the requirements on how to account for modified financial assets when the modification does not result in derecognition. It stipulates that in such circumstances, an entity shall recalculate the gross carrying amount of the financial asset and recognise a modification gain or loss in profit or loss.

5. Appendix A of IFRS 9 defines a modification gain or loss as follows:

> The amount arising from adjusting the gross carrying amount of a financial asset to reflect the renegotiated or modified contractual cash flows. The entity recalculates the gross carrying amount of a financial asset as the present value of the estimated future cash payments or receipts through the expected life of the renegotiated or modified financial asset that are discounted at the financial asset's original effective interest rate (or the original credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets) or, when applicable, the revised effective interest rate calculated in accordance with paragraph 6.5.10. When estimating the expected cash flows of a financial asset, an entity shall consider all contractual terms of the financial asset (for example, prepayment, call and similar options) but shall not consider the expected credit losses, unless the financial asset is a purchased or originated credit-impaired financial asset, in which case an entity shall also consider the initial expected

> credit losses that were considered when calculating the original credit-adjusted effective interest rate.

6. As discussed in paragraphs BC5.227-229 of IFRS 9, during their redeliberations of the 2013 *Impairment* Exposure Draft, the IASB considered how the impairment model should apply to financial assets with modified contractual cash flows where the modification does not result in derecognition.

7. They concluded that where the financial instrument had not been derecognised, it could not be considered 'new' from an accounting perspective and as a result the impairment model should continue to apply to such modified financial assets in the same way as it does for other unmodified financial instruments.

8. Consequently, paragraph 5.5.12 of IFRS 9 clarifies that:

> If the contractual cash flows on a financial asset have been renegotiated or modified and the financial asset was not derecognised, an entity shall assess whether there has been a significant increase in the credit risk of the financial instrument in accordance with paragraph 5.5.3 by comparing:
>
> (a) the risk of a default occurring at the reporting date (based on the modified contractual terms); and
>
> (b) the risk of a default occurring at initial recognition (based on the original, unmodified contractual terms).

9. Having made the assessment above, an entity would then be able to determine whether it was appropriate to measure lifetime ECL or 12-month ECL on the modified financial asset in accordance with paragraphs 5.5.3 and 5.5.5 of IFRS 9:

> Subject to paragraphs 5.5.13–5.5.16, at each reporting date, an entity shall measure the loss allowance 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.
>
> Subject to paragraphs 5.5.13–5.5.16, if, at the reporting date, the credit risk on a financial instrument has not

> increased significantly since initial recognition, an entity shall measure the loss allowance for that financial instrument at an amount equal to 12-month expected credit losses.

10. When measuring ECL, an entity must consider the guidance in paragraph 5.5.18 of IFRS 9:

> When measuring expected credit losses, an entity need not necessarily identify every possible scenario. However, it shall consider the risk or probability that a credit loss occurs by reflecting the possibility that a credit loss occurs and the possibility that no credit loss occurs, even if the possibility of a credit loss occurring is very low.

11. Illustrative Example 11 of IFRS 9, which is reproduced in Appendix I, sets out how the requirements above should be applied to financial assets where there have been modifications to the contractual cash flows that have not resulted in derecognition.

12. In accordance with paragraph 7 of IAS 8, an entity is obliged to consider all IFRSs relevant to a transaction insofar as the effect is considered material:

> When an IFRS specifically applies to a transaction, other event or condition, the accounting policy or policies applied to that item shall be determined by applying the IFRS.

13. As regards the presentation requirements, paragraph 85 of IAS 1 stipulates that:

> An entity shall present additional line items (including by disaggregating the line items listed in paragraph 82), headings and subtotals in the statement(s) presenting profit or loss and other comprehensive income when such presentation is relevant to an understanding of the entity's financial performance.

14. Furthermore, paragraph 82(ba) of IAS 1 states that the profit or loss section or the statement of profit or loss shall include line items that present the following amounts for the period:

> (ba) impairment losses (including reversals of impairment losses or impairment gains) determined in accordance with Section 5.5 of IFRS 9;

15. Paragraph 35J of IFRS 7 requires disclosures about the nature and effect of modifications of contractual cash flows on financial assets that have not resulted in derecognition and the effect of such modifications on the measurement of ECL.

16. In order to meet the requirements above, an entity should be mindful of the objective of credit risk disclosures explained in paragraph 35B of IFRS 7—ie to enable users of financial statements to understand the effect of credit risk on the amount, timing and uncertainty of future cash flows.

17. As noted in paragraph BC48Z of IFRS 7, during redeliberations of the 2013 *Impairment* Exposure Draft, the IASB received feedback that the modification requirements in IFRS 9 should be limited to modifications of credit-impaired assets or modifications undertaken for credit risk management purposes. The Board rejected these views and confirmed that the scope of these requirements applies to all modifications of contractual cash flows, regardless of the reason for the modification, and cited the following rationale:

> In making this decision, the Board noted that an amortised cost carrying amount equates to the present value of the expected contractual cash flows, discounted at the effective interest rate. Consequently, the carrying amount should reflect changes in those contractual cash flows, irrespective of the reason for the modification occurring. In addition, it was noted that any change in contractual terms will have an impact on credit risk, even if small…

18. Consequently, the disclosures required by paragraph 35J of IFRS 7 apply to all modifications.

Potential implementation issue identified

19. Consider the following example:

> Bank A originates a loan which meets the conditions of paragraph 4.1.2 of

IFRS 9 and is therefore measured at amortised cost.

Subsequently Bank A determines that the loan has suffered a significant increase in credit risk and consequently recognises lifetime expected credit losses.

Immediately after, Bank A renegotiates the terms of the loan with the borrower in order to take into consideration the amounts that Bank A expects the borrower can repay—ie the contractual cash flows of the original loan are reduced.

The following is assumed:

(a) the loan is not credit-impaired at initial recognition and is not in a fair value hedge relationship;

(b) the modification does not result in derecognition; and

(c) there has been no observable reduction in credit risk and so the entity is required to continue to calculate lifetime expected credit losses.

Questions:

1. How should Bank A calculate the modification gain or loss?

2. How should Bank A measure the new lifetime expected credit loss allowance at the reporting date?

3. How should the modification gain or loss and movement on the expected credit loss allowance be presented?

4. What modifications are included in the disclosures required by paragraph 35J of IFRS 7?

Question 1—How should Bank A calculate the modification gain or loss?

20. The modification has not resulted in derecognition of the financial asset. Consequently, Bank A recalculates the gross carrying amount of the financial asset in accordance with paragraph 5.4.3 of IFRS 9 in order to determine the appropriate modification gain or loss to be recognised in profit or loss.

21. When estimating the expected cash flows for the purposes of determining the new gross carrying amount, Bank A considers the definition of a modification gain or loss in Appendix A of IFRS 9, which stipulates that expected credit losses must not be considered.

Question 2—How should Bank A measure the new lifetime ECL allowance at the reporting date?

22. Having considered the requirements in paragraph 5.5.12 of IFRS 9, Bank A is still of the view that there has been a significant increase in credit risk since initial recognition and is therefore required to calculate a new lifetime ECL on the modified financial asset at the reporting date, as prescribed by paragraph 5.5.3 of IFRS 9.

23. When measuring the new ECL, Bank A considers the requirements in paragraph 5.5.18 of IFRS 9, which clarifies that while an entity need not consider every possible scenario, it must at least consider the possibility either that a credit loss occurs or that no credit loss occurs (even if the risk of a credit loss occurring is considered very low).

24. In this example, because Bank A has renegotiated the contractual cash flows in a way that reflects expectations of how much the borrower will be able to repay, it is possible that that Bank A now considers that there is a lower probability of a credit event occurring. In accordance with paragraph 5.5.18 of IFRS 9 however, Bank A is still required to consider this possibility of credit loss when measuring ECL. It cannot be assumed to be nil, because the expected cash flows used for the purposes of the ECL measurement take into account the possibility of credit losses, whereas the revised gross carrying value will not take such expected credit losses into account. The movement in ECL allowance should be recognised in profit or loss.

Question 3—How should the modification gain or loss and movement on the ECL allowance be presented?

25. IFRS 9 does not prescribe which line item in the statement of profit or loss and other comprehensive income modification gains and losses should be presented.

26. However, Bank A should consider the requirements in paragraph 85 of IAS 1 regarding when it is appropriate to present additional line items in the statement of profit or loss and other comprehensive income. Consequently, if separate presentation of the modification gain or loss would be considered relevant to an

understanding of the entity's performance, Bank A should present them separately.

27. As regards the movement on the ECL allowance, Bank A should consider the requirements in paragraph 82(ba) of IAS 1, which requires a separate line item in the statement of profit or loss in respect of impairment losses and reversals.

Question 4—What modifications are included in the disclosures required by paragraph 35J of IFRS 7?

28. As explained in paragraph BC48Z of IFRS 7, the disclosures required by paragraph 35J of IFRS 7 apply to all modifications of contractual cash flows.

29. Consequently, Bank A must consider the overall objective of credit risk disclosures as explained in paragraph 35B of IFRS 7 and should comply with the disclosure requirement relating to modifications insofar as the items in question are considered to be important to achieving that objective.

Questions for members of ITG
What are your views on the issues presented above?

A1. Appendix I—IFRS 9 Implementation Guidance

Example 11—modification of contractual cash flows

IE66 Bank A originates a five-year loan that requires the repayment of the outstanding contractual amount in full at maturity. Its contractual par amount is CU1,000 with an interest rate of 5 per cent payable annually. The effective interest rate is 5 per cent. At the end of the first reporting period (Period 1), Bank A recognises a loss allowance at an amount equal to 12-month expected credit losses because there has not been a significant increase in credit risk since initial recognition. A loss allowance balance of CU20 is recognised.

IE67 In the subsequent reporting period (Period 2), Bank A determines that the credit risk on the loan has increased significantly since initial recognition. As a result of this increase, Bank A recognises lifetime expected credit losses on the loan. The loss allowance balance is CU30.

IE68 At the end of the third reporting period (Period 3), following significant financial difficulty of the borrower, Bank A modifies the contractual cash flows on the loan. It extends the contractual term of the loan by one year so that the remaining term at the date of the modification is three years. The modification does not result in the derecognition of the loan by Bank A.

IE69 As a result of that modification, Bank A recalculates the gross carrying amount of the financial asset as the present value of the modified contractual cash flows discounted at the loan's original effective interest rate of 5 per cent. In accordance with paragraph 5.4.3 of IFRS 9, the difference between this recalculated gross carrying amount and the gross carrying amount before the modification is recognised as a modification gain or loss. Bank A recognises the modification loss (calculated as CU300) against the gross carrying amount of the loan, reducing it to CU700, and a modification loss of CU300 in profit or loss.

IE70 Bank A also remeasures the loss allowance, taking into account the modified contractual cash flows and evaluates whether the loss allowance for the loan shall continue to be measured at an amount equal to lifetime expected credit losses. Bank A compares the current credit risk (taking into consideration the modified cash flows) to the credit risk (on the original unmodified cash flows) at initial recognition. Bank A determines that the loan is not credit-impaired at the reporting date but that credit risk has still significantly increased compared to the credit risk at initial recognition and continues to measure the loss allowance at an amount equal to lifetime expected credit losses. The loss allowance balance for lifetime expected credit losses is CU100 at the reporting date.

Period	**Beginning gross carrying amount**	**Impair-ment (loss)/gain**	**Modifi-cation (loss)/gain**	**Interest revenue**	**Cash flows**	**Ending gross carrying amount**	**Loss allow-ance**	**Ending amortised cost amount**
	A	B	C	D Gross: A × 5%	E	F = A + C + D – E	G	H = F – G
1	CU1,000	(CU20)		CU50	CU50	CU1,000	CU20	CU980
2	CU1,000	(CU10)		CU50	CU50	CU1,000	CU30	CU970
3	CU1,000	(CU70)	(CU300)	CU50	CU50	CU700	CU100	CU600

IE71 At each subsequent reporting date, Bank A evaluates whether there is a significant increase in credit risk by comparing the loan's credit risk at initial recognition (based on the original, unmodified cash flows) with the credit risk at the reporting date (based on the modified cash flows), in accordance with paragraph 5.5.12 of IFRS 9.

IE72 Two reporting periods after the loan modification (Period 5), the borrower has outperformed its business plan significantly compared to the expectations at the modification date. In addition, the outlook for the business is more positive than previously envisaged. An assessment of all reasonable and supportable information that is available without undue cost or effort indicates that the overall credit risk on the loan has decreased and that the risk of a default occurring over the expected life of the loan has decreased, so Bank A adjusts the borrower's internal credit rating at the end of the reporting period.

IE73 Given the positive overall development, Bank A re-assesses the situation and concludes that the credit risk of the loan has decreased and there is no longer a significant increase in credit risk since initial recognition. As a result, Bank A once again measures the loss allowance at an amount equal to 12-month expected credit losses.