STAFF PAPER

11 December 2015

Project	**Transition Resource Group for Impairment of Financial Instruments**
Paper topic	Measurement of expected credit losses for charge cards

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Introduction

1. This paper addresses an issue raised by a submitter regarding the application of the impairment requirements of IFRS 9 *Financial Instruments* (2014) to a particular type of credit facility that does not have an absolute credit limit, for example, in the case of a charge card issued by a bank.

2. This paper:
   (a) sets out the relevant accounting requirements in IFRS 9 and IFRS 7 *Financial Instruments: Disclosures;*
   (b) summarises the potential implementation issue raised by the submitter; and
   (c) asks the members of the Transition Resource Group for Impairment of Financial Instruments (‘the ITG’) for their views on the issue identified.

Accounting requirements

3. IFRS 9 defines credit losses as follows [emphasis added]:

> The difference between **all contractual cash flows that are due to an entity in accordance with the contract** and all the cash flows that the entity expects to receive (ie all cash shortfalls), discounted at the original effective interest rate (or credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets)….[…]

4. Further application guidance regarding the measurement of expected credit losses in the context of loan commitments is set out in paragraph B5.5.30 of IFRS 9 [emphasis added]:

> **B5.5.30** For undrawn loan commitments, a credit loss is the present value of the difference between:
>
> (a) the **contractual cash flows that are due to the entity if the holder of the loan commitment draws down the loan**; and
>
> (b) the cash flows that the entity expects to receive if the loan is drawn down

5. In order to determine the amount required by paragraph B5.5.30(a), an entity is required to estimate the expected usage of the undrawn facility. In this regard, paragraph B5.5.31 of IFRS 9 clarifies that the period over which expected drawdowns should be estimated depends on whether the entity is measuring 12-month or lifetime expected credit losses.

6. Paragraph 5.5.19 of IFRS 9 stipulates 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 period is consistent with business practice.

7. However, paragraph 5.5.20 of IFRS 9 provides one exception to this requirement [emphasis added]:

> **5.5.20** 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.

8. Paragraphs B5.5.39 of IFRS 9 provides further application guidance, which sets out the general characteristics associated with the type of financial instruments described in paragraph 5.5.20 of IFRS 9 [emphasis added]:

> **B5.5.39** 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**.

9. Paragraphs BC5.254–BC5.261 of IFRS 9[1] set out the rationale behind the exception contained in paragraph 5.5.20 of IFRS 9.

10. During the April 2015 ITG meeting, some ITG members requested clarification regarding the scope of paragraph 5.5.20 of IFRS 9. Paragraphs 36 and 37 of the April ITG meeting notes summarises the ITG discussions on this point:

> **36** Some ITG members requested clarification of the exception outlined in paragraph 5.5.20 of IFRS 9. Specifically, they asked whether it could be applied to the example presented by analogising the 6-month mortgage loan to a revolving credit facility that has been fully drawn at the reporting date.
>
> **37** In this regard, it was noted that paragraph 5.5.20 of IFRS 9 applies to financial instruments with a drawn and undrawn component where the borrower has flexibility in how frequently they make drawdowns on the facility and consequently it is possible that the facility could be fully drawn or fully undrawn at the reporting date. It was also

[1] Appendix A reproduces paragraph BC5.254-BC5.261 in their entirety.

> highlighted that the Basis of Conclusions of IFRS 9 provides further context around the types of financial instruments that were envisaged would fall under the scope of paragraph 5.5.20 ie revolving credit facilities such as credit cards and overdraft facilities. However, in the example presented, the facility is not of a revolving nature and the borrower does not have any such flexibility regarding drawdowns. Consequently, it would not be appropriate to analogise to the financial instruments described in paragraph 5.5.20 of IFRS 9.

11. At the September 2015 ITG meeting, an issue relating to how to estimate future drawdowns on revolving credit facilities when an entity has a history of allowing customers to exceed their contractually set credit limits was discussed. The views of ITG members in respect of this issue are set out in paragraph 37 of the ITG September 2015 Meeting Summary:

> **37** ITG members noted that the exception for some types of revolving credit facilities set out in paragraph 5.5.20 of IFRS 9 relates to the contractual commitment period and does not address the contractual credit limit. ITG members noted that the Standard was clear in this regard and consequently, that it would not be appropriate to analogise this specific exception to the contractual credit limit.

12. Paragraph 35B of IFRS 7 sets out the objectives of credit risk disclosures and, more specifically, paragraph 35B(a) of IFRS 7 notes that credit risk disclosures shall provide information about an entity's credit risk management practices and how they relate to the recognition and measurement of expected credit losses and paragraph 35G of IFRS 7 requires an entity to explain, amongst other things, the assumptions used to measure expected credit losses. In addition, paragraph 35E of IFRS 7 notes that in order to meet the objective of credit risk disclosures, an entity may be required to disclose additional information:

> **35E** If the disclosures provided in accordance with paragraphs 35F–35N are insufficient to meet the objectives in paragraph 35B, an entity shall disclose additional information that is necessary to meet those objectives.

Potential implementation issue identified

13. The submitter acknowledges that the discussions which took place during the September ITG meeting reaffirmed that IFRS 9 limits the estimation of future drawdowns on a revolving credit facility falling within the scope of paragraph 5.5.20 of IFRS 9 to the contractually agreed credit limit. However, the submitter also notes that a few ITG members observed that in some cases, a revolving credit facility might not have an absolute credit limit and that this situation may require further analysis.

14. Consequently, the submitter wishes to explore this issue in more detail and describes below the typical features of a credit facility that does not have an absolute credit limit:

> Bank A issues charge cards to its retail customers in Country X with the following terms:
>
> - no absolute spending limit—Bank A approves charges (ie customer transactions) dynamically at time of sale based on the customer's perceived spending capacity using statistical models and inputs such as spending history and known income;
> - Bank A can suspend the ability to make charges or cancel the card account at its discretion even if the customer pays on time and the card account is not in default;
> - balances are due in full at the end of each month and do not bear interest; however, late fees apply if an unpaid balance is not paid at the end of the month;
> - if Bank A suspends the ability to make charges or cancels the card account, the customer must still pay for all existing charges but there is no change in the due date—ie these balances remain due and payable at the end of the month; and
> - merchants pay a convenience fee to Bank A when customers charge the card.

15. Within the context of the example provided above, ie when there is no contractually agreed credit limit, the submitter asks whether future drawdowns should be taken into account when estimating expected credit losses. The submitter presents two views along with supporting arguments for each:

    (a) *View 1:* Future drawdowns should not be taken into account because the contractual credit limit should be considered to be zero.

    (b) *View 2:* Future drawdowns should be taken into account because the contractual credit limit should be considered to be unlimited.

16. In support of View 1, the submitter notes that at the September 2015 ITG meeting, it was reconfirmed that the IFRS 9 impairment model is based on the contractual terms of the financial instrument (unless a more specific exception applies). In this example, there is no contractually agreed credit limit and Bank A provides approval on a transaction-by-transaction basis. Consequently, in the submitter's view, the credit limit could be considered to be zero and in that case, future drawdowns would not be taken into account when measuring expected credit losses. Furthermore, the submitter observes that if the credit limit is considered to be zero, it could be argued that the charge card described above is not within the scope of paragraph 5.5.20 of IFRS 9 to begin with. This is because the exception in paragraph 5.5.20 relates to financial instruments that include both a loan and an undrawn commitment component, but if the contractual credit limit is considered to be zero, there is no undrawn commitment component. In that case, the submitter observes that the requirements of paragraph 5.5.19 of IFRS 9 would apply to the individual drawn balances.

17. In support of View 2, the submitter observes that the discussions at the September 2015 ITG meeting related to credit cards, which had contractually agreed credit limits, whereas in the case of a charge card, there are no such contractually agreed credit limits. In the absence of a contractually agreed credit limit, in the submitter's view, the credit limit could be considered to be unlimited and consequently, estimated future drawdowns should be taken into account when

measuring expected credit losses. The submitter also observes that if the credit limit is considered to be unlimited, then the charge cards described above should be within the scope of paragraph 5.5.20 of IFRS 9. This is because there is both a loan and undrawn commitment component and they are similar in nature to revolving credit cards, in that drawdowns are intended at the inception of the credit facility and the resulting drawn balance can go up and down.

Review of accounting requirements

18. We note that in order to determine the appropriate accounting treatment for the charge cards described by the submitter, it is firstly necessary for Bank A to establish the contractual terms of the financial instrument.

19. We observe that consistently with the general application of IFRS[2], the contractual credit limit should be determined in accordance with the substantive contractual terms of the financial instrument. In this example, we note that there is no contractually agreed credit limit and consequently Bank A would be required to consider:

    (a) whether there is an implied credit limit; and if so

    (b) what that credit limit should be, ie zero, unlimited or another specific limit.

20. In making this determination, we observe that Bank A should consider all relevant facts and circumstances including how the charge cards are managed in practice. For example, Bank A should consider whether the charge cards are managed in a way that is consistent with point of sale approval being provided on a transaction by transaction basis or whether they are in fact managed similarly to other contractual commitments to extend credit.

[2] As discussed in paragraph BC3.26 of the *Conceptual Framework for Financial Reporting*.

21. Once Bank A has determined the nature of the credit limit, Bank A would then consider whether the charge cards could fall within the scope of paragraph 5.5.20 of IFRS 9 and in this regard, we first note that the exception set out in paragraph 5.5.20 of IFRS 9 was intended to be limited in nature. We also note that in order to determine whether the charge cards fall within the scope of paragraph 5.5.20 of IFRS 9, Bank A would be required to consider the description set out in paragraph 5.5.20 of IFRS 9 together with the related application guidance in paragraph B5.5.39 of IFRS 9.

22. In making this assessment, we note that, in addition to considering whether there is in fact a commitment to extend credit, Bank A would be required to consider all of the characteristics of the charge cards, including how these financial instruments are managed.[3]

23. We note that if Bank A determines that the charge cards fall within the scope of paragraph 5.5.20 of IFRS 9, Bank A would be required to measure expected credit losses for both the drawn and undrawn components 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.

24. Finally, we note that in order to meet the objectives of credit risk disclosures described in paragraph 35B of IFRS 7, an entity must provide information about its credit risk management practices and how they relate to the recognition and measurement of expected credit losses and that in accordance with paragraph 35G of IFRS 7, an entity is required to explain the assumptions used to measure expected credit losses. Within the context of the example presented by the submitter in paragraph 14, we observe that these disclosures would be important. In addition, in accordance with paragraph 35E of IFRS 7, an entity should also be

[3] See Agenda Paper 2 of the December 2015 ITG meeting, which contains a more detailed discussion pertaining to the scope of paragraph 5.5.20 of IFRS 9.

mindful of whether it is necessary to disclose additional information in order to meet the overall objectives of credit risk disclosures.

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

Appendix A

Extracts from the Basis for Conclusions of IFRS 9

BC5.254 Respondents to the 2013 Impairment Exposure Draft widely supported the proposed requirements for loan commitments and financial guarantee contracts in general, and no new arguments were raised that the IASB considered would call into question its prior analysis. However, the majority of respondents that supported including loan commitments within the scope of the proposed model noted that expected credit losses on some loan commitments should be estimated over the behavioural life of the financial instrument, instead of over the contractual commitment period. Although they noted that the use of the contractual period would be conceptually appropriate, there was concern that using the contractual period:

(a) would be contrary to how the exposures are handled for credit risk management and regulatory purposes;

(b) could result in insufficient allowances for the exposures arising from these contracts; and

(c) would result in outcomes for which no actual loss experience exists on which to base the estimates.

BC5.255 Respondents noted that the use of the contractual period was of particular concern for some types of loan commitments that are managed on a collective basis, and for which an entity usually has no practical ability to withdraw the commitment before a loss event occurs and to limit the exposure to credit losses to the contractual period over which it is committed to extend the credit. Respondents noted that this applies particularly to revolving credit facilities such as credit cards and overdraft facilities. For these types of facilities, estimating the expected credit losses over the behavioural life of the instruments was viewed as more faithfully representing their exposure to credit risk.

BC5.256 Respondents also noted that those revolving credit facilities lack a fixed term or repayment structure and allow borrowers flexibility in how frequently they make drawdowns on the facility. Such facilities can be viewed as a combination of an undrawn loan commitment and a drawn-down loan asset. Typically, these facilities can be contractually cancelled by a lender with little or no notice, requiring repayment of any drawn balance and cancellation of any undrawn commitment under the facility. There would be no need on a conceptual basis to recognise expected credit losses on the undrawn portion of these facilities, because the exposure period could be as little as one day under the proposals in the 2013 Impairment Exposure Draft.

BC5.257 Outreach performed during the comment period on the 2013 Impairment Exposure Draft indicated that, in practice, lenders generally continue to extend credit under these types of financial instruments for a duration longer than the contractual minimum and only withdraw the facility if observable credit risk on the facility has increased significantly. The IASB noted that, for such facilities, the contractual maturities are often set for protective reasons and are not actively enforced as part of the normal credit risk management processes. Participants also noted that it may be difficult to withdraw undrawn commitments on these facilities for commercial reasons unless there has been an increase in credit risk. Consequently, economically, the contractual ability to demand repayment and cancel the undrawn commitment does not necessarily prevent an entity from being exposed to credit losses beyond the contractual notice period.

BC5.258 The IASB noted that the expected credit losses on these type of facilities can be significant and that restricting the recognition of a loss allowance to expected credit losses in the contractual notice period would arguably be inconsistent with the notion of expected credit losses (ie it would not reflect actual expectations of loss) and would not reflect the underlying economics or the way in which those facilities are managed for credit risk purposes. The IASB also noted that the amount of expected credit losses for these facilities could be significantly lower if the exposure is restricted to the contractual period, which may be inconsistent with an economic assessment of that exposure.

BC5.259 The IASB further noted that from a credit risk management perspective, the concept of expected credit losses is as relevant to off balance sheet exposures as it is to on balance sheet exposures. These types of financial instruments include both a loan (ie financial asset) and an undrawn commitment (ie loan commitment) component and are managed, and expected credit losses are estimated, on a facility level. In other words there is only one set of cash flows from the borrower that relates to both components. Expected credit losses on the on balance sheet exposure (the financial asset) are not estimated separately from the expected credit losses on the off balance sheet exposure (the loan commitment). Consequently, the period over which the expected credit losses are estimated should reflect the period over which the entity is expected to be exposed to the credit risk on the instrument as a whole.

BC5.260 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.

BC5.261 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.