STAFF PAPER

October 2015

IASB Meeting

Project	**Transition Resource Group for Impairment of Financial Instruments**
Paper topic	Update on current status

CONTACT(S)	Bernadette Whittick	bwhittick@ifrs.org	+44 (0)20 7246 0552
	Hannah King	hking@ifrs.org	+44 (0)20 7246 6961

Purpose

1. The purpose of this paper is to:

   (a) provide the IASB with a summary of the activities of the Transition Resource Group for Impairment of Financial Instruments (‘the ITG’, ‘the group’); and

   (b) inform the IASB about an issue raised at the September meeting of the ITG relating to the measurement of expected credit losses for revolving credit facilities.

2. We are not asking the IASB to make any decisions at this meeting.

3. This paper is structured as follows:

   (a) background and summary of activities to date;

   (b) summary of issue to be discussed with the IASB; and

   (c) Appendix A—ITG submissions log.

Background and summary of activities to date

4. The ITG was established in 2014 with the aim of providing support to the IASB’s stakeholders who are implementing the new expected credit loss requirements in IFRS 9 *Financial Instruments* (2014). The group will have a limited life and will

not publish any guidance. However, where necessary, matters can be referred back to the IASB or to the IFRS Interpretations Committee. Any new authoritative guidance would be published through the normal channels and be subject to normal due process.

5. The ITG's full terms of reference can be found on the IASB's website.[1]

6. There have been 3 meetings of the ITG to date: 1 introductory conference call in December 2014 and 2 full meetings in April and September 2015. A further meeting is scheduled for December 2015.

7. While no further meetings have been scheduled or are planned for 2016, the group will remain in place and further meetings will be convened if circumstances warrant it.

8. In accordance with the ITG's terms of reference, questions submitted to the ITG should meet the following criteria:

   (a) the question is a potential implementation issue related to the impairment requirements of IFRS 9;

   (b) the issue indicates that the new impairment requirements may be applied in different ways, resulting in possible diversity in practice. The submission should include a detailed description of the possible ways in which the new Standard can be applied; and

   (c) the potential implementation issue is expected to be pervasive, ie relevant to a wide group of stakeholders. A description of why the issue is expected to be pervasive should be included with each submission.

9. To date, 21 submissions have been received and a total of 15 issues have been discussed during the ITG meetings in April and September 2015. Out of the 6 submissions not discussed, 1 has been carried forward and will be discussed at the December meeting. The remaining 5 issues will not be discussed, because they were either:

[1] Link to IASB Website - ITG terms of reference

(a) requests for more examples, which the ITG is not constituted to provide; or

(b) did not meet the ITG's submissions criteria set out in paragraph 8, because they were not potential implementation issues related to the impairment requirements.

10. A full listing of the submissions received to date can be found on the IASB website[2] and is also reproduced in Appendix A to this paper.

11. Overall, the ITG's discussions have highlighted that members generally agreed with the accounting analysis presented by the staff for each of the issues raised by submitters. Consequently, the discussions have focussed on the various implementation challenges and how these were being addressed in practice.

12. However, during the September 2015 meeting, the staff agreed to inform the IASB about an issue raised relating to the measurement of expected credit losses for revolving credit facilities. We set out in paragraphs 13-23 a summary of this issue.

Summary of issue to be discussed with the IASB—Measurement of expected credit losses in respect of revolving credit facilities

13. The impairment model in IFRS 9 is based on the contractual terms of a financial instrument. Specifically:

(a) the definition of credit losses refers to a comparison between the 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;[3] and

(b) 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.[4]

[2] Link to IASB Website - ITG Submissions Log

[3] Appendix A of IFRS 9

[4] Paragraph 5.5.19 of IFRS 9

14. Consequently, and as set out in paragraphs B5.5.29-B5.5.30 of IFRS 9, when measuring expected credit losses, IFRS 9 requires an entity to determine the contractual cash flows that are due in accordance with the contract and compare these to the cash flows the entity expects to receive. This principle is applicable to both drawn loans and undrawn loan commitments.

15. For drawn loans, the contractual cash flows due to the entity will be clear, because the amounts have already been drawn down by the borrower. However, for undrawn loan commitments, this is not the case, because there is uncertainty over the amounts that will be drawn down in the future. Consequently, and in accordance with paragraph B5.5.31 of IFRS 9, an entity is required to estimate the expected usage of the undrawn facility in order to establish the cash flows that would be due to the entity in accordance with the contract if the borrower draws down.

16. However, paragraph 5.5.20 of IFRS 9 contains one exception to the principle set out in paragraph 13 for some types of revolving credit facilities such as credit cards and overdraft facilities.[5] This exception requires that for facilities of this nature, expected credit losses should be measured for a period in excess of the maximum contractual commitment period:

> **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.

17. The reason behind this exception relates to 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

[5] The related application guidance is set out in paragraphs B5.5.39-B5.5.40 of IFRS 9.

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. 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. In these cases, both the drawn and undrawn balance are managed together from a credit risk perspective and in practice 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, which could be too late to prevent some or all of the expected credit losses. Respondents noted that restricting the recognition of expected credit losses to the contractual notice period would not reflect the underlying economics or the way in which these facilities were managed.

18. During the IASB's deliberations on this matter, the IASB reconfirmed that the maximum period over which expected credit losses should be measured should be limited to the contractual period over which the entity is committed to provide credit (or a shorter period considering prepayments) as this is the correct conceptual outcome[6]. However, in order to address the concerns raised by respondents in respect of the financial instruments of the specific type described above, the IASB decided to introduce the limited exception set out in paragraph 5.5.20 of IFRS 9.

19. Consequently, when a facility meets the requirements of paragraph 5.5.20 of IFRS 9, an entity is required to measure expected credit losses over a period in excess of the contractual commitment period. Within the context of the undrawn element of these facilities, this means that the entity is also required to estimate future drawdowns over that longer period.

20. One of the submissions received for the September 2015 ITG meeting raised a question regarding the measurement of expected credit losses in respect of facilities meeting the requirements of paragraph 5.5.20 of IFRS 9. The submitter noted that in practice, the contractual credit limit on these facilities is often

[6] Paragraph BC5.260 of IFRS 9

exceeded when the customer reaches default. Consequently, the submitter questioned whether it would be appropriate to include amounts in excess of the contractual credit limit when estimating expected future drawdowns in respect of the undrawn element of these facilities. In other words, the submitter asked whether the exception set out in paragraph 5.5.20 of IFRS 9 regarding the contractual commitment period could be extended to the contractually agreed credit limit when an entity has a history of allowing customers to exceed their contractually set credit limits.

21. The staff analysis of this issue, as set out in paragraphs 12-15 of Agenda Paper 3 for the September ITG meeting[7], concluded that it would not be appropriate to extend the specific exception outlined in paragraph 5.5.20 of IFRS 9 relating to the contractual commitment period to the contractual credit limit. The rationale for this conclusion was based on:

    (a) the definition of credit losses and related application guidance set out in IFRS 9 which requires an entity to determine the cash flows due in accordance with the contract; and

    (b) the fact that the exception set out in paragraph 5.5.20 of IFRS 9 was intended to be a narrow exemption, so it would not be appropriate to analogise to this exception.

22. ITG members agreed with the analysis presented by the staff and noted that IFRS 9 was clear in this regard.

23. However, a number of ITG members pointed out that in practice, the tenor and amount of revolving credit facilities were inextricably linked, because banks not only extend credit for a period in excess of their maximum contractual commitment period but also allow customers to make drawdowns in excess of the maximum contractually agreed credit limit as notified to the customer. Consequently, they noted that if amounts in excess of the maximum contractually agreed credit limits are not taken into account, there would be a potential disconnect between the accounting and credit risk management view.

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[7] Agenda Paper 3 - September ITG

24. The staff would like to note that:

 (a) the issue would appear to be limited to very specific types of revolving credit facilities;

 (b) the issue was not raised as a concern by respondents commenting on the 2013 *Impairment Exposure Draft;*

 (c) despite the concerns raised, ITG members agreed that the requirements of IFRS 9 were clear and that the exception set out in paragraph 5.5.20 of IFRS 9 could not be extended to the contractual credit limit; and

 (d) the exception set out in paragraph 5.5.20 of IFRS 9 which requires an entity to consider a period in excess of the contractual commitment period was intentionally limited in nature due to the lack of conceptual basis as highlighted in paragraph 18.

25. At this juncture the staff is not proposing any further action on the issue. The staff will keep the IASB informed of any further developments relating to this issue as the implementation of IFRS 9 progresses.

Question for the IASB
Do IASB members have any views on the issue outlined in the paper?

Appendix A—ITG submissions log

Submission Number	Topic	Summary of issue	ITG meeting date	ITG agenda referen	Current status
1	Purchased or originated credit-impaired financial assets	Request for more guidance and illustrative examples about how to account for purchased or originated credit-impaired financial assets.			Request for additional guidance and examples to be included in the Standard is outside the remit of the ITG and therefore the staff do not plan to discuss the request at an ITG meeting.
2	12 month expected credit losses	Request for more illustrative examples to demonstrate how 12 month expected credit losses differs from lifetime expected credit losses.			Request for illustrative examples to be included in the Standard is outside the remit of the ITG and therefore the staff do not plan to discuss the request at an ITG meeting.
3 & 4	Time value of money	Request for illustrative examples to explain how the requirement to take into account the time value of money for measuring expected credit losses when using (a) an explicit 'probability of default' approach; and (b) a loss rate approach.			Request for illustrative examples to be included in the Standard is outside the remit of the ITG and therefore the staff do not plan to discuss the request at an ITG meeting.
5	Transition requirements	If an entity first applies IFRS 9 (2014) in an interim period such that the initial date of application is not the beginning of an annual reporting period, should earlier interim periods in the annual period containing the first period of application be restated?			General transition issue does not meet the ITG submission criteria (see http://www.ifrs.org/About-us/IASB/Advisory-bodies/ITG-Impairment-Financial-Instrument/Pages/Submit-an-issue.aspx) and therefore staff do not plan to discuss the issue at an ITG meeting.
6	Measurement of expected credit losses in respect of a modified financial asset	How should expected credit losses in respect of a modified financial asset (that is not derecognised) be measured and what are the related presentation and disclosure requirements?	22 April 2015	8	Discussed at ITG meeting on 22 April 2015 (see Meeting Summary*).
7	Expected credit losses – measurement date	Is there a requirement to measure expected credit losses at dates other than the reporting date eg the date of derecognition or date of initial recognition?	22 April 2015	7	Discussed at ITG meeting on 22 April 2015 (see Meeting Summary*).
8	The maximum period to consider when measuring expected credit losses	What is maximum period to consider when measuring expected credit losses in the case of a portfolio of financial assets managed on a collective basis and where the contractual terms include a lender extension option?	22 April 2015	1	Discussed at ITG meeting on 22 April 2015 (see Meeting Summary*).
9	Loan commitments – scope	Do the impairment requirements in IFRS 9 apply when a retailer issues store accounts that enable customers to buy goods or services in the future from the retailer on credit?	22 April 2015	3	Discussed at ITG meeting on 22 April 2015 (see Meeting Summary*).
10	Financial guarantee contracts held by an entity	(1) Should a financial guarantee contract be accounted for as an integral element of the guaranteed debt instrument or accounted for separately? (2) Should an entity consider the ability to recover cash flows from an integral financial guarantee contract held when assessing whether there has been a significant increase in credit risk of the guaranteed debt instrument? (3) If a financial guarantee contract is accounted for separately, how should an entity recognise an asset for its right to compensation under the financial guarantee contract?	22 April 2015	5	Question (2) was discussed at ITG meeting on 22 April 2015 (see Meeting Summary*). Accounting for financial guarantee contracts by the holder (questions (1) and (3)) is outside the remit of the ITG and therefore staff do not plan to discuss them at an ITG meeting.
11	Measurement of expected credit losses for an issued financial guarantee contract	Should the measurement of expected credit losses for financial guarantee contracts issued by the entity consider future premium receipts due from the holder and, if so, how?	22 April 2015	6	Discussed at ITG meeting on 22 April 2015 (see Meeting Summary*).
12	Loan commitments – scope	Do the impairment requirements in IFRS 9 apply in the period from inception to commencement of a finance lease?	22 April 2015	3	Discussed at ITG meeting on 22 April 2015 (see Meeting Summary*).
13	Revolving credit facilities	(1) How to determine the appropriate period to consider when measuring expected credit losses for assets in stage 1, stage 2 and stage 3. (2) How to determine the date of initial recognition for the purposes of assessing whether there has subsequently been a significant increase in credit risk.	22 April 2015	4	Discussed at ITG meeting on 22 April 2015 (see Meeting Summary*).
14	Forecasts of future economic conditions	Should (and if so, how) events and revised forecasts of future economic conditions be incorporated into the assessment of significant increases in credit risk and measurement of expected credit losses if the new information arises: (i) after economic forecasts have been made but before the reporting date; and (ii) between the reporting date and the date of signing the financial	22 April 2015	2	Discussed at ITG meeting on 22 April 2015 (see Meeting Summary*).
15	Significant increases in credit risk	How an entity should determine whether there has been a significant increase in credit risk for a portfolio of loans where identical pricing and contractual terms are applied to customers across broad credit quality bands, for example, most retail loans.	16 Sept 2015	1	To be discussed at the ITG meeting on 16 September 2015
16	Use of forward-looking information	Whether forward-looking information should be incorporated into impairment reviews differently; for example, on a portfolio by portfolio basis and/or on an entity basis (for macroeconomic information).	16 Sept 2015	4	To be discussed at the ITG meeting on 16 September 2015
17	Reasonable and supportable forward-looking information	How to determine whether forward-looking information about emerging issues and uncertain future events is reasonable and supportable for inclusion in the assessment of expected credit losses.	16 Sept 2015	4	To be discussed at the ITG meeting on 16 September 2015
18	Measurement of expected credit losses for revolving credit facilities	Whether an exposure in excess of the contractually agreed credit limit should be used when estimating the exposure at default in respect of revolving facilities where an entity has a history of allowing customers to exceed their contractually set credit limits.	16 Sept 2015	3	To be discussed at the ITG meeting on 16 September 2015
19	Holders accounting for collateral	(1) What is meant by collateral and other credit enhancements that are 'part of the contractual terms' when measuring expected credit losses for the related financial asset? (2) How should the holder account for credit enhancements that are treated as a separate unit of account?			(1) The staff are analysing question (1) and will provide a further update in due course. (2) Accounting for financial guarantee contracts by the holder is outside the remit of the ITG and therefore staff do not plan to discuss question (2) at an ITG meeting.
20	Significant increases in credit risk	Whether an entity can use behavioural indicators of credit risk as a proxy for the assessment of significant increases in credit risk since initial recognition.	16 Sept 2015	1	To be discussed at the ITG meeting on 16 September 2015
21	Use of changes in the risk of a default occurring over the next 12 months when assessing for significant increases in credit risk.	Whether, and if so to what extent, an entity would be required to perform an annual review to determine whether circumstances still support the use of a 12-month approximation of changes in the lifetime risk of default occurring.	16 Sept 2015	2	To be discussed at the ITG meeting on 16 September 2015

* The Meeting Summary for the ITG meeting held on 22 April 2015 is available at: http://www.ifrs.org/Meetings/MeetingDocs/Other%20Meeting/2015/April/ITG-meeting-summary-22-April-2015.pdf