

STAFF PAPER

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| Project | Transition Resource Group for Impairment of Financial Instruments | | |
| Paper topic | Significant increases in credit risk | | |
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This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IFRS Transition Resource Group for Impairment of Financial Instruments. It does not purport to represent the views of any individual members of either board or staff. Comments on the application of IFRSs do not purport to set out acceptable or unacceptable application of IFRSs.

Introduction

1. This paper addresses two issues relating to how an entity should determine whether there has been a significant increase in credit risk in accordance with the impairment requirements of IFRS 9 *Financial Instruments* (2014):
 - (a) the first issue relates to 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; and
 - (b) the second issue relates to 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.
2. This paper:
 - (a) sets out the relevant accounting requirements in IFRS 9 and IFRS 7 *Financial Instruments: Disclosures*;
 - (b) summarises the potential implementation issues 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. Paragraph 5.5.4 of IFRS 9 states that the objective of the impairment requirements is to recognise lifetime expected credit losses for all financial instruments for which there have been a significant increase in credit risk since initial recognition:

5.5.4 The objective of the impairment requirements is to recognise lifetime expected credit losses for all financial instruments for which there have been significant increases in credit risk since initial recognition — whether assessed on an individual or collective basis — considering all reasonable and supportable information, including that which is forward-looking.

4. Accordingly, paragraph 5.5.9 of IFRS 9 requires an entity to assess, at each reporting date, whether the credit risk on a financial instrument has increased significantly since initial recognition, ie the assessment is relative in nature:

5.5.9 At each reporting date, an entity shall assess whether the credit risk on a financial instrument has increased significantly since initial recognition. When making the assessment, an entity shall use the change in the risk of a default occurring over the expected life of the financial instrument instead of the change in the amount of expected credit losses. To make that assessment, **an entity shall compare the risk of a default occurring on the financial instrument as at the reporting date with the risk of a default occurring on the financial instrument as at the date of initial recognition and consider reasonable and supportable information, that is available without undue cost or effort, that is indicative of significant increases in credit risk since initial recognition.** *[emphasis added]*

5. Paragraph B5.5.9 of IFRS 9 further highlights the relative nature of the assessment of significant increases in credit risk, noting that the significance of the change in credit risk since initial recognition will depend on the risk of a default occurring as at initial recognition:

B5.5.9 The significance of a change in the credit risk since initial recognition depends on the risk of a default occurring as at initial recognition. Thus, a given change, in absolute terms, in the risk of a default occurring will be more significant for a financial instrument with a lower initial risk of a default occurring compared to a financial instrument with a higher initial risk of a default occurring.

6. Paragraphs B5.5.5 and B5.5.6 of IFRS 9 acknowledge that the assessment of significant increases in credit risk can be done on a collective basis as long as this approach facilitates the timely identification of significant increases in credit risk and does not obscure significant increases in credit risk. Where an entity is unable to do so, it must recognise lifetime expected credit losses on the portion of financial assets for which credit risk is deemed to have increased significantly:

B5.5.5 For the purpose of determining significant increases in credit risk and recognising a loss allowance on a collective basis, an entity can group financial instruments on the basis of shared credit risk characteristics **with the objective of facilitating an analysis that is designed to enable significant increases in credit risk to be identified on a timely basis**. The entity should not obscure this information by grouping financial instruments with different risk characteristics....[....]

B5.5.6 Paragraph 5.5.4 requires that lifetime expected credit losses are recognised on all financial instruments for which there has been significant increases in credit risk since initial recognition. In order to meet this objective, if an entity is not able to group financial instruments for which the credit risk is considered to have increased significantly since initial recognition based on shared credit risk

characteristics, the entity **should recognise lifetime expected credit losses on a portion of the financial assets for which credit risk is deemed to have increased significantly.**[.....] *[emphasis added]*

7. An entity is also required to make the assessment of significant increases in credit risk on transition in accordance with paragraphs 7.2.18 – 7.2.20 of IFRS 9. Where such an assessment would require undue cost and effort, an entity applies paragraph 7.2.20 of IFRS 9 and recognises lifetime expected credit losses until the point of derecognition:

7.2.18 At the date of initial application, an entity shall use reasonable and supportable information that is available without undue cost or effort to determine the credit risk at the date that a financial instrument was initially recognised (or for loan commitments and financial guarantee contracts at the date that the entity became a party to the irrevocable commitment in accordance with paragraph 5.5.6) and compare that to the credit risk at the date of initial application of this Standard.

7.2.19 When determining whether there has been a significant increase in credit risk since initial recognition, an entity may apply:

(a) the requirements in paragraphs 5.5.10 and B5.5.22–B5.5.24; and

(b) the rebuttable presumption in paragraph 5.5.11 for contractual payments that are more than 30 days past due if an entity will apply the impairment requirements by identifying significant increases in credit risk since initial recognition for those financial instruments on the basis of past due information.

7.2.20 If, at the date of initial application, determining whether there has been a significant increase in credit risk since initial recognition would require undue cost or effort, **an entity shall recognise a loss allowance at an**

amount equal to lifetime expected credit losses at each reporting date until that financial instrument is derecognised (unless that financial instrument is low credit risk at a reporting date, in which case paragraph 7.2.19(a) applies). *[emphasis added]*

8. Consequently, in accordance with the guidance set out above, an entity is required to make an assessment of significant increases in credit risk (either on an individual or collective basis) both on transition (in accordance with paragraphs 7.2.18 – 7.2.20 of IFRS 9) and on an ongoing basis (in accordance with paragraph 5.5.9 of IFRS 9) in order to determine whether 12-month or lifetime expected credit losses should be recognised.
9. Regarding the timing of significant increases in credit risk, paragraph B5.5.2 of IFRS 9 notes that credit risk typically increases significantly before a financial instrument becomes past due and consequently, an entity must also consider all reasonable and supportable information including that which is forward-looking:

B5.5.2 Lifetime expected credit losses are generally expected to be recognised before a financial instrument becomes past due. Typically, credit risk increases significantly before a financial instrument becomes past due or other lagging borrower-specific factors (for example, a modification or restructuring) are observed. Consequently when reasonable and supportable information that is more forward-looking than past due information is available without undue cost or effort, it must be used to assess changes in credit risk.
10. However, paragraph 5.5.11 of IFRS 9 provides further guidance around the use of past due information. It reinforces that reasonable and supportable forward-looking information must be used if available without undue cost or effort but notes that in some circumstances past due information may be used and introduces a rebuttable presumption that a significant increase in credit risk has occurred when financial assets are more than 30 days past due:

5.5.11 If reasonable and supportable forward-looking information is available without undue cost or effort, an entity cannot rely solely on past due information when determining whether credit risk has increased significantly since initial recognition. However, **when information that is more forward-looking than past due status (either on an individual or a collective basis) is not available without undue cost or effort, an entity may use past due information to determine whether there have been significant increases in credit risk since initial recognition.** Regardless of the way in which an entity assesses significant increases in credit risk, **there is a rebuttable presumption that the credit risk on a financial asset has increased significantly since initial recognition when contractual payments are more than 30 days past due.** [...] [*emphasis added*]

11. Paragraph B5.5.12 of IFRS 9 notes that an entity may apply various approaches when assessing whether there has been a significant increase in credit risk and different approaches for different financial instruments. However, an entity must always consider the change in the risk of default occurring since initial recognition, the expected life of the financial instrument and all reasonable and supportable information that is available without undue cost and effort that may affect credit risk:

B5.5.12 An entity may apply various approaches when assessing whether the credit risk on a financial instrument has increased significantly since initial recognition or when measuring expected credit losses. An entity may apply different approaches for different financial instruments. An approach that does not include an explicit probability of default as an input per se, such as a credit loss rate approach, can be consistent with the requirements in this Standard, provided that an entity is able to separate the changes in the risk of a default occurring from changes in other drivers of expected credit losses, such as collateral,

and **considers the following when making the assessment:**

(a) the change in the risk of a default occurring since initial recognition;

(b) the expected life of the financial instrument;

(c) and reasonable and supportable information that is available without undue cost or effort that may affect credit risk. [emphasis added]

12. IFRS 9 also acknowledges that many factors will need to be taken into account in credit risk analysis and that it should be tailored to the specific financial instrument being assessed. Specifically, paragraph B5.5.16 notes:

B5.5.16 Credit risk analysis is a **multifactor and holistic analysis**; whether a specific factor is relevant, and its weight compared to other factors, **will depend on the type of product, characteristics of the financial instruments and the borrower as well as the geographical region...[...]** [emphasis added]

13. In order to assist entities in making the assessment of significant increases in credit risk, IFRS 9 provides both application guidance and illustrative examples.

14. Paragraph B5.5.17 of IFRS 9 sets out a non-exhaustive list of information that may be relevant in making the assessment. This includes factors such as internal and external indicators of credit risk, changes to contractual terms, actual and expected performance/ behaviours and forecasts of future conditions. This guidance is reproduced in full in Appendix A.

15. Illustrative Examples 1 – 7 of IFRS 9 illustrate possible ways to assess whether there have been significant increases in credit risk since initial recognition. However, as noted in paragraph IE6 of IFRS 9, there are limitations to these examples:

IE6 The following examples illustrate possible ways to assess whether there have been significant increases in credit risk since initial recognition. For simplicity of

illustration, the following examples only show one aspect of the credit risk analysis. However, the assessment of whether lifetime expected credit losses should be recognised is a multifactor and holistic analysis that considers reasonable and supportable information that is available without undue cost or effort and that is relevant for the particular financial instrument being assessed.

16. During its deliberations, the IASB considered and rejected a number of alternative approaches for determining significant increases in credit risk, which are summarised in paragraphs BC5.159-BC5.168 of IFRS 9. These approaches included: an absolute level of credit risk, a change in the credit risk management objective, credit underwriting policies and a counterparty assessment.
17. Regarding an absolute level of credit risk, the IASB provided the following rationale behind its decision to reject this approach:

BC5.160 [.....] It would not approximate the economic effect of initial credit loss expectations and subsequent changes in expectations. In addition, if the absolute credit risk threshold for recognising lifetime expected credit losses was too high, too many financial instruments would be below the threshold and expected credit losses would be understated. If the absolute threshold was too low, too many financial instruments would be above the threshold, overstating the expected credit losses (for example, financial instruments with a high credit risk that an entity prices appropriately to compensate for the higher credit risk would always have lifetime expected credit losses recognised)...[.....]

18. However, despite having rejected this approach, the IASB also noted that in some situations it may be appropriate for an entity to make the assessment of significant increases in credit risk by comparing a maximum initial credit risk to the credit risk at the reporting date:

BC5.161 Although the IASB rejected using an absolute level of credit risk for the recognition of lifetime expected credit losses, it noted that **the assessment of significant increases in credit risk could be implemented more simply by determining the maximum initial credit risk accepted by the reporting entity for a particular portfolio of financial instruments and then comparing the credit risk of financial instruments in that portfolio at the reporting date to that maximum initial credit risk.** However, the IASB noted that this would **only be possible for portfolios of financial instruments with similar credit risk at initial recognition. Such an approach would enable a change in credit risk to be the basis for the recognition of lifetime expected credit losses**, but does not require specific tracking of the credit risk on an individual financial instrument since initial recognition.
[emphasis added]

19. Illustrative Example 6 of IFRS 9 illustrates how the guidance above could be applied to a portfolio of automobile loans¹. This example is reproduced in full in Appendix B.
20. When making the assessment of significant increases in credit risk, IFRS 9 allows entities a choice of whether to apply the following operational simplification in respect of financial instruments that are considered to be low credit risk at the reporting date:

5.5.10 An entity may assume that the credit risk on a financial instrument has not increased significantly since initial recognition if the financial instrument is determined to

¹ Illustrative Example 6 uses changes in internal credit risk grades to make an assessment of significant increases in credit risk. However, as noted in paragraph IE6 of IFRS 9, for simplicity the illustrative examples consider only one factor of credit risk analysis. An entity is required to consider all reasonable and supportable information that is available without undue cost or effort and that is relevant for the particular financial instrument being assessed. Furthermore, Illustrative Example 1 (reproduced in Appendix C) specifically notes that changes in internal credit risk grades may not be determinative of significant increases in credit risk.

have low credit risk at the reporting date (see paragraphs B5.5.22–B5.5.24).

21. The application guidance for this operational simplification is set out in paragraphs B5.5.22–B5.5.24. This guidance clarifies that while an entity can use its own internal measures in order to determine whether a financial instrument has a low credit risk, that measure should reflect a globally understood definition of low credit risk:

B5.5.23 To determine whether a financial instrument has low credit risk, **an entity may use its internal credit risk ratings or other methodologies that are consistent with a globally understood definition of low credit risk and that consider the risks and the type of financial instruments that are being assessed.** An external rating of ‘investment grade’ is an example of a financial instrument that may be considered as having low credit risk. However, financial instruments are not required to be externally rated to be considered to have low credit risk. They should, however, be considered to have low credit risk from a market participant perspective taking into account all of the terms and conditions of the financial instrument. *[emphasis added]*

22. IFRS 7 requires an entity to disclose information regarding its credit risk management practices and how the entity has made the assessment of significant increases in credit risk. Specifically, paragraphs 35F and 35G of IFRS 7 state:

35F An entity shall explain its credit risk management practices and how they relate to the recognition and measurement of expected credit losses. To meet this objective an entity shall disclose information that enables users of financial statements to understand and evaluate:

- (a) **how an entity determined whether the credit risk of financial instruments has increased significantly since initial recognition, including, if and how:**

(i) **financial instruments are considered to have low credit risk** in accordance with paragraph 5.5.10 of IFRS 9, including the classes of financial instruments to which it applies; and

[.....]

(c) **how the instruments were grouped if expected credit losses were measured on a collective basis;**

35G An entity shall explain the inputs, assumptions and estimation techniques used to apply the requirements in Section 5.5 of IFRS 9. For this purpose an entity shall disclose:

(a) the basis of inputs and assumptions and the estimation techniques used to:

[.....]

(ii) **determine whether the credit risk of financial instruments have increased significantly since initial recognition;** and

[.....]

[emphasis added]

Potential implementation issues identified

Issue 1

23. The submitter presents the following scenario:

- Bank X holds a retail loan portfolio comprised of large volumes of relatively small value individual loans.
- Bank X assigns internal credit risk grades to each individual loan exposure from grade 1 (lowest credit risk) to grade 10 (highest credit risk) where the internal credit risk increases exponentially as the credit risk rating deteriorates. The credit risk grades include all available information about the customer and also incorporate the information set out in paragraph B5.5.17 of IFRS 9 to the extent it is relevant.
- The portfolio is made up of various different types of loan products. For example, consider Product A:
 - the maximum credit risk acceptable for Product A is a credit grade of 5—ie when a customer applies for this product, they will be only accepted if the credit grade is 5 or lower;
 - once an application is accepted, the contractual terms and pricing of Product A will be identical for all customers taking up this product;
- Consequently, the resulting sub-portfolio that contains only Product A (Portfolio A), may contain loans with origination credit grades ranging from 1 to 5 but all loans will have the same contractual terms.
- From a credit risk management perspective, Bank X does not specifically track the credit risk history on individual loans since initial recognition—ie while Bank X monitors the current credit risk on individual loans, it does not use the credit risk information at initial recognition for credit risk management purposes. However, based on the credit risk management practice, which includes underwriting practices and ongoing review of the performance of the portfolios, loans in Portfolio A would always be originated at a credit grade of 5 or lower.

24. The submitter raises the following questions within the context of Portfolio A:
- (a) Would it be appropriate for Bank X to use a single threshold (such as a breach of a specific credit grade) for the purposes of determining whether there has been a significant increase in credit risk?
 - (b) Alternatively, are there any other approaches, such as defining a significant increase in credit risk as an increase in a certain number of credit risk grades since initial recognition that would be more appropriate? For example:
 - (i) defining a significant increase in credit risk as an increase of a certain number of notches (for example, 2 grades) since initial recognition; or
 - (ii) defining a significant increase in credit risk based on a different number of notches depending on the loans' initial credit grade (for example, 3 notches from grade 2, 2 notches from grade 3, and 1 notch from grade 4).
25. Regarding the use of a single threshold (referred to in paragraph 24(a)), the submitter notes the following:
- (a) in order to meet the objectives of the impairment requirements, the single threshold chosen should represent the point at which Bank X considers there to be a significant increase in credit risk (which would be a point prior to a missed payment);
 - (b) because the same contractual terms are offered to all customers in the portfolio, it could be argued that all customers in Portfolio A have similar initial credit risk and that a single threshold (ie breach of a specific credit risk grade) could be used for the purposes of determining whether there has been a significant increase in credit risk. The submitter considers that this would be similar to Portfolio 1 in Illustrative Example 6 in IFRS 9; and
 - (c) as long as the current credit risk grade of a loan does not exceed the maximum credit risk deemed acceptable for the original pricing point, it does not result in an economic loss, because the expected credit losses

have not exceeded initial expectations that would have been implicit in the initial pricing. Given the credit risk that was considered acceptable at origination (ie grade 5 or below), the submitter thinks that it can also be argued that an increase that breaches this threshold is significant as long as Bank X considers that movements between grades 1 and 5 do not represent significant increases in credit risk in the context of Portfolio A.

26. Regarding the alternative approaches (referred to in paragraph 24(b)), the submitter notes that both of these alternative approaches would be more onerous than applying a single threshold from an operational perspective, because they would involve the tracking of initial credit grades of individual loans. The submitter makes the following observations:
- (a) defining a significant increase in credit risk as an increase of 2 grades since initial recognition would result in a loan with an initial credit grade of 2 being transferred to Stage 2 when the credit grade increases to 4, but at the same time, Bank X is willing to originate new loans at credit grade 4 with exactly the same contractual terms and the new loan would remain in Stage 1. The submitter considers that it may be difficult to explain why, in this context, a transfer based on a fixed number of notches (for example, 2 notches) is appropriate, because neither loan has breached the maximum initial credit grade acceptable for Product A. Furthermore, the submitter notes that using, for example, a 2 notch movement in grades in all cases, as evidence of a significant increase in credit risk may not be appropriate; and
 - (b) in their view defining a significant increase in credit risk based on a different number of notches depending on the loans initial credit grade (for example, 3 notches from grade 2, 2 notches from grade 3, and 1 notch from grade 4) would lead to a result very similar to the single threshold approach.

Review of accounting requirements

27. We note that in accordance with paragraphs 5.5.4 and 5.5.9 of IFRS 9, the objective of the impairment requirements is to recognise lifetime expected credit losses for all financial instruments for which there has been a significant increase in credit risk since initial recognition. Consequently, we observe that the IFRS 9 impairment model is based on an assessment of relative increases in credit risk since initial recognition rather than the identification of an absolute point of credit risk at which an entity considers that the risk of default is likely. As noted in paragraph BC5.161 of IFRS 9, an absolute approach to determining significant increases in credit risk was explicitly considered and rejected by the IASB.
28. In accordance with the above we note that an entity is required to assess, at each reporting date, whether the credit risk on a financial instrument has increased significantly since initial recognition and consequently, an entity is required to be able to assess the changes in credit risk of financial instruments since initial recognition (either on an individual or collective basis).
29. In making the assessment of significant increases in credit risk, we note that in accordance with paragraphs B5.5.16 and B5.5.17 of IFRS 9, credit risk analysis is a multi-factor and holistic analysis, which needs to be tailored to the financial instruments being assessed. Furthermore, we observe that:
- (a) credit risk typically increases significantly before a financial instrument becomes past due (as highlighted by paragraph B5.5.2 of IFRS 9) and consequently an entity must consider all reasonable and supportable information including that which is forward-looking; and
 - (b) in accordance with paragraph B5.5.12 of IFRS 9, while an entity may apply various approaches when assessing changes in credit risk and different approaches for different financial instruments, it must always consider; the change in the risk of default occurring since initial recognition, the expected life of the financial instrument and all

reasonable and supportable information that is available without undue cost and effort that may affect credit risk.

30. We observe that in the submitter's example, the maximum credit grade acceptable for loans in Portfolio A is 5 and that all loans meeting that criteria will have the same contractual terms and pricing. The submitter suggests in paragraph 25(c) that if a loan remains at credit grade 5 or below, then a transfer to Stage 2 may not be appropriate because there would be no economic loss (as the expected credit losses would not have exceeded initial expectations that would have been implicit in the initial pricing). In this regard, we note the following:

- (a) we acknowledge that the link between pricing and credit risk was considered by the IASB in developing the expected credit loss model and that this concept underlies the rationale for why lifetime expected credit losses are only recognised when a significant increase in credit risk occurs. However, we also note that IFRS 9 requires that lifetime expected credit losses be recognised when a significant increase in credit risk occurs and furthermore the Standard clearly envisages a range of approaches to making this assessment. Specifically, we observe that while pricing and contractual terms are noted in paragraph B5.5.17 of IFRS 9 as being relevant factors to consider in making the assessment of significant increases in credit risk, other factors such as actual and expected performance/behaviours and forecasts of future conditions must also be taken into account to the extent appropriate. Ultimately, the Standard requires an entity to use all available evidence in order to facilitate an assessment of the change in the risk of a default occurring; and
- (b) we observe that if the pricing for all loans in portfolio A is considered to be commensurate with a credit grade of 5, then it follows that for loans with better credit grades (eg grades 1 or 2) at origination, the expected (credit risk adjusted) margin on those loans would have been greater than that for the higher risk loans (eg grades 4 or 5). However, as these lower credit risk loans suffer subsequent increases in credit risk

(eg moving to credit grades 3, 4 or 5), this expected margin on these loans would decrease and consequently, we note that relative to its initial expectations, Bank A would indeed suffer an economic loss in respect of these exposures.

31. We also observe that in the example presented, Bank X assigns internal credit risk grades to each individual loan exposure from grade 1 (lowest credit risk) to grade 10 (highest credit risk) where the internal credit risk increases exponentially as the credit risk rating deteriorates. Furthermore, we observe that in the example presented, these credit risk grades include all available information about the customer and also incorporate the information set out in paragraph B5.5.17 of IFRS 9 to the extent it is relevant. In the regard, we note the following:

- (a) where an entity derives internal credit risk grades by taking into account all reasonable and supportable information, including that which is forward-looking, ie taking into account the information listed in paragraph B5.5.17 to the extent relevant at each reporting date, it may then be appropriate to use movements in internal credit risk grades as a means of identifying significant increases in credit risk. However, in making this determination, an entity should be mindful of achieving the overall objective of the impairment requirements—ie to recognise lifetime expected credit losses for all financial instruments for which there has been a significant increase in credit risk since initial recognition; and
- (b) credit risk rating systems vary and so care needs to be taken when referring to movements in credit grades. For example, in some credit risk rating systems, the risk of default increases exponentially as the credit risk rating deteriorates whereas in others, this might not be the case. Furthermore, we note that in accordance with paragraph B5.5.9 of IFRS 9, prima facie, a smaller absolute change in the risk of default occurring will be more significant for a high quality asset than for a low quality one. For example, if in probability of default terms, the initial risk of default occurring on two otherwise identical loans is 0.5% and

3% respectively, if the risk of default increases by an amount of 0.5%, then this movement will be more significant for the loan with the lower initial risk of default occurring (so in a probability of default sense it takes a *smaller* movement to cause a high quality asset to move to a lifetime expected credit loss measure than a low quality one). Consequently, the number of notches that represents a significant change in credit risk will depend on the risk of default associated with the grades of initial credit risk.

32. The principle established in paragraph B5.5.9 of IFRS 9 and its applicability to different types of credit rating system may be best illustrated by way of an example:
- (a) credit rating system where grade 1 is the lowest credit risk and grade 10 is the highest credit risk and where the risk of default increases linearly as the credit risk rating deteriorates – ie a single notch movement from credit grade 1 to credit grade 2 represents the same increase in the risk of a default occurring as compared to a single notch movement from credit grade 4 to 5. In this scenario, the lower credit risk asset will likely require a lesser number of notch increases to be considered to represent a significant increase in credit risk in accordance with IFRS 9 as compared to the higher credit risk asset; whereas
 - (b) credit rating system where grade 1 is the lowest credit risk and grade 10 is the highest credit risk and where the risk of default increases exponentially as the credit risk rating deteriorates – ie a single notch movement in credit grade 1 to credit grade 2 represents a smaller increase in the risk of a default occurring as compared to a single notch movement from credit grade 4 to 5. In this scenario, it is more likely a significant increase in credit risk could be determined by an equivalent number of notch movements for the lower and higher credit risk assets.
33. We note that paragraph 5.5.4 of IFRS 9 requires that lifetime expected credit losses be recognised on all financial assets that have significantly increased in credit risk and furthermore, that paragraph 5.5.9 of IFRS 9 requires that this

assessment be made by comparison to the credit risk at initial recognition. We also note that an observation is made in paragraph BC5.161 of IFRS 9 that in some cases, the change in credit risk may in practice be able to be determined for portfolios of financial instruments that have a similar credit risk at initial recognition using a form of absolute approach. Under this approach, an entity may be able to determine the maximum initial credit risk accepted for a particular portfolio of financial instruments and then compare the credit risk of financial instruments in that portfolio at the reporting date to that maximum initial credit risk in order to make the assessment of significant increases in credit risk.

34. Illustrative Example 6 of IFRS 9² (reproduced in full in Appendix B) presents an example of how the approach described in paragraph 33 above could be applied. In this example, the entity holds a portfolio of automobile loans with similar terms and conditions and assigns internal credit risk grades to each individual loan exposure from grade 1 (lowest credit risk) to grade 10 (highest credit risk), where the internal credit risk increases exponentially as the credit risk rating deteriorates. The entity identifies two sub-portfolios: portfolio 1, containing loans originated with a credit grade of 3 or 4 and portfolio 2, containing loans originated with a credit grade of between 4 and 7. The entity concludes that only loans in portfolio 1 have a similar initial credit risk such that a single threshold could be used to identify significant increases in credit risk. The initial credit risk of loans in portfolio 2 is considered to be too diverse for such an approach to meet the objective of the impairment requirements set out in paragraph 5.5.4 of IFRS 9. This is because the entity considers that there could be a significant increase in credit risk before the point at which the entity would no longer originate new loans on the same terms.
35. Consequently, we observe that in order to identify portfolios of loans with a similar initial credit risk such that significant increases in credit risk can be identified by use of a single threshold, an entity should not rely only on factors such as the contractual terms and pricing of those loans. This is because such an

² As pointed out in paragraph IE6 of IFRS 9, the Illustrative Examples in IFRS 9 aim to set out possible ways of identifying significant increases in credit risk and are simplified in nature.

approach may fail to identify significant relative increases in credit risk and thus may not result in the timely recognition of lifetime expected credit losses.

36. Therefore, in the example presented by the submitter, we observe that the entity would need to be able to demonstrate that increases in credit risk grade below grade 5 would not be considered to represent a significant increase in credit risk by taking into consideration factors other than the contractual terms and pricing of the loans (as explained in paragraph 30 above).
37. Additionally, we observe that in accordance with paragraphs 35F and 35G IFRS 7, an entity is required to disclose how it has made the assessment of significant increases in credit risk.

Question 1 for ITG members

What are your views on Issue 1 as presented above?

Issue 2

38. The submitter notes that paragraph 5.5.9 of IFRS 9 requires an entity to assess at each reporting date whether the credit risk on a financial instrument has increased significantly since initial recognition, taking into consideration reasonable and supportable information that is available without undue cost or effort. Furthermore, the submitter notes that paragraph 5.5.10 of IFRS 9 permits an entity to assume that there has not been a significant increase in credit risk for financial instruments that have a low credit risk at the reporting date. Consequently, the submitter observes that unless the low credit risk simplification can be used, these requirements will necessitate the tracking of credit risk since origination.
39. The submitter notes that this is a very challenging aspect of implementing the IFRS 9 impairment requirements (in particular for revolving credit facilities such as credit cards and residential secured lines of credit) — both on transition and on an ongoing basis. Consequently, many entities are developing complex models to address this requirement. However, others are considering whether there are less complex approaches that could serve as a proxy for a more sophisticated measure of relative increases in credit risk.
40. The submitter observes that one of the less complex approaches being considered is whether and if so, in what circumstances, it would be possible to make the assessment of significant increases in credit risk on the basis of behavioural indicators. The submitter notes that use of these indicators would mean that a comparison is not explicitly made with the risk of a default occurring as at initial recognition so could in that sense be viewed as absolute. Behavioural indicators of this nature could include the following:
- (a) where a customer has made only the minimum monthly repayment for a specified number of months;
 - (b) where a customer has failed to make a payment on a loan with a different lender; or
 - (c) where a customer has failed to make a specified number of minimum monthly repayments.

41. The submitter considers that it should be possible to use such measures of behaviour in order to demonstrate that a financial instrument had a low credit risk at the reporting date in accordance with paragraph 5.5.10 of IFRS 9. However, the submitter notes that using measures as a means of evidencing significant increases in credit risk since initial recognition is more challenging. The submitter considers that it may be appropriate to use such measures where an entity could show that the kind of behaviours noted above served as a proxy for capturing the increase in credit risk since initial recognition.
42. The submitter acknowledges that the challenge with such a practical simplification is that it will depend on the starting point; ie:
- (a) if the customer's initial risk of default is consistent with a super-prime rating, the kind of deteriorating behaviour noted above would probably signal a significant increase in credit risk; whereas
 - (b) if the customer's initial risk of default is consistent with sub-prime, then such behaviour might not signal a significant increase in credit risk.
43. The submitter asks whether, and if so, in what circumstances, the behavioural measures of the type described above could be used as an appropriate proxy for relative increases in credit risk in such a way that the requirements of paragraph 5.5.9 of IFRS 9 would be met.

Review of accounting requirements

44. Regarding the assessment of significant increases in credit risk, we note that in accordance with paragraph 5.5.9 of IFRS 9, an entity is required to assess at each reporting date whether the credit risk on a financial instrument has increased significantly since initial recognition, taking into consideration reasonable and supportable information that is available without undue cost or effort. Furthermore, we note that there is a similar requirement upon transition in accordance with paragraphs 7.2.18 - 7.2.20 of IFRS 9. Consequently, the assessment is relative in nature and, as noted in paragraph B5.5.9 of IFRS 9, this means that the change in the credit risk since initial recognition will depend on the risk of a default occurring at initial recognition.
45. We note that in accordance with paragraph B5.5.12 of IFRS 9, an entity may apply various approaches when assessing changes in credit risk and different approaches for different financial instruments. However, we observe that an entity must always consider; the change in risk of default occurring since initial recognition, the expected life of the financial instrument and all reasonable and supportable information that is available without undue cost and effort that may affect credit risk.
46. We observe that where an entity identifies specific behavioural indicators of credit risk such as those noted by the submitter in paragraph 40 and can demonstrate that they represent an appropriate proxy for assessing significant increases in credit risk such that the requirements of paragraphs 5.5.4 and 5.5.9 of IFRS 9 are met, then it may be appropriate to use such indicators in making the assessment. For example, it may be possible to establish a correlation between behavioural indicators and the risk of a default occurring.³
47. However, we note that in accordance with paragraph B5.5.2 of IFRS 9, credit risk typically increases significantly before a financial instrument becomes past due

³ We note that one such example of behavioural indicator being correlated with the risk of a default occurring is the 30 days past due rebuttable presumption set out in paragraph 5.5.11 of IFRS 9. As noted in paragraph BC5.191 of IFRS 9, the IASB was told that there was generally a correlation between financial instruments that are more than 30 days past due and significant increases in the risk of a default occurring.

and consequently, an entity must also consider all reasonable and supportable information including that which is forward looking. In this regard, we observe that the behavioural indicators noted in paragraph 40 are not forward looking in nature and consequently they may not result in the timely identification of significant increases in credit risk.

48. Furthermore, we observe that in accordance with paragraphs B5.5.5 and B5.5.6 of IFRS 9, where an entity can group financial instruments on the basis of shared credit risk characteristics then it may be appropriate to perform the assessment of significant increases in credit risk on a collective basis. This can be done on condition that it this serves to meet the overall objective of the impairment requirements—ie to recognise lifetime expected credit losses for all financial instruments for which there have been a significant increase in credit risk since initial recognition, taking into consideration all reasonable and supportable information, including that which is forward-looking.
49. Regarding the low credit risk simplification, we note that in accordance with paragraph 5.5.10 of IFRS 9, an entity is permitted to assume that there has not been a significant increase in credit risk for financial instruments that have a low credit risk at the reporting date. We note that in accordance with paragraph B5.5.23 of IFRS 9, an external rating of ‘investment grade’ is given as an example of a financial instrument that may be considered as having low credit risk but that an entity can use its own internal credit risk ratings or other methodologies as long as they are consistent with a globally understood definition of low credit risk.
50. In this regard, we would question whether the types of behavioural indicators, in particular those relying on delinquency information, as noted by the submitter in paragraph 40 would be considered represent a globally accepted definition of low credit risk.
51. However, we note that as a relief *upon transition*, in accordance with paragraph 7.2.19 of IFRS 9, an entity can apply the rebuttable presumption in paragraph 5.5.11 of IFRS 9 for contractual payments that are more than 30 days past due if an entity will apply the impairment requirements by identifying significant

increases in credit risk since initial recognition for those financial instruments on the basis of past due information.

52. Finally, we note that in accordance with paragraphs 35F and 35G IFRS 7, an entity is required to disclose how it has made the assessment of significant increases in credit risk and how it has identified financial instruments with low credit risk at the reporting date.

Question 2 for ITG members

What are your views on Issue 2 as presented above?

Appendix A

IFRS 9: Additional Extracts from the Standard

B5.5.17 The following non-exhaustive list of information may be relevant in assessing changes in credit risk:

- (a) significant changes in internal price indicators of credit risk as a result of a change in credit risk since inception, including, but not limited to, the credit spread that would result if a particular financial instrument or similar financial instrument with the same terms and the same counterparty were newly originated or issued at the reporting date.
- (b) other changes in the rates or terms of an existing financial instrument that would be significantly different if the instrument was newly originated or issued at the reporting date (such as more stringent covenants, increased amounts of collateral or guarantees, or higher income coverage) because of changes in the credit risk of the financial instrument since initial recognition.
- (c) significant changes in external market indicators of credit risk for a particular financial instrument or similar financial instruments with the same expected life. Changes in market indicators of credit risk include, but are not limited to:
 - (i) the credit spread;
 - (ii) the credit default swap prices for the borrower;
 - (iii) the length of time or the extent to which the fair value of a financial asset has been less than its amortised cost; and

- (iv) other market information related to the borrower, such as changes in the price of a borrower's debt and equity instruments.
- (d) an actual or expected significant change in the financial instrument's external credit rating.
- (e) an actual or expected internal credit rating downgrade for the borrower or decrease in behavioural scoring used to assess credit risk internally. Internal credit ratings and internal behavioural scoring are more reliable when they are mapped to external ratings or supported by default studies.
- (f) existing or forecast adverse changes in business, financial or economic conditions that are expected to cause a significant change in the borrower's ability to meet its debt obligations, such as an actual or expected increase in interest rates or an actual or expected significant increase in unemployment rates.
- (g) an actual or expected significant change in the operating results of the borrower. Examples include actual or expected declining revenues or margins, increasing operating risks, working capital deficiencies, decreasing asset quality, increased balance sheet leverage, liquidity, management problems or changes in the scope of business or organisational structure (such as the discontinuance of a segment of the business) that results in a significant change in the borrower's ability to meet its debt obligations.
- (h) significant increases in credit risk on other financial instruments of the same borrower.
- (i) an actual or expected significant adverse change in the regulatory, economic, or technological environment of the borrower that results in a significant change in the borrower's ability to meet its debt obligations, such as a

decline in the demand for the borrower's sales product because of a shift in technology.

(j) significant changes in the value of the collateral supporting the obligation or in the quality of third-party guarantees or credit enhancements, which are expected to reduce the borrower's economic incentive to make scheduled contractual payments or to otherwise have an effect on the probability of a default occurring. For example, if the value of collateral declines because house prices decline, borrowers in some jurisdictions have a greater incentive to default on their mortgages.

(k) a significant change in the quality of the guarantee provided by a shareholder (or an individual's parents) if the shareholder (or parents) have an incentive and financial ability to prevent default by capital or cash infusion.

(l) significant changes, such as reductions in financial support from a parent entity or other affiliate or an actual or expected significant change in the quality of credit enhancement, that are expected to reduce the borrower's economic incentive to make scheduled contractual payments. Credit quality enhancements or support include the consideration of the financial condition of the guarantor and/or, for interests issued in securitisations, whether subordinated interests are expected to be capable of absorbing expected credit losses (for example, on the loans underlying the security).

(m) expected changes in the loan documentation including an expected breach of contract that may lead to covenant waivers or amendments, interest payment holidays, interest rate step-ups, requiring additional collateral or guarantees, or other changes to the contractual framework of the instrument.

(n) significant changes in the expected performance and behaviour of the borrower, including changes in the payment status of borrowers in the group (for example, an increase in the expected number or extent of delayed contractual payments or significant increases in the expected number of credit card borrowers who are expected to approach or exceed their credit limit or who are expected to be paying the minimum monthly amount).

(o) changes in the entity's credit management approach in relation to the financial instrument; ie based on emerging indicators of changes in the credit risk of the financial instrument, the entity's credit risk management practice is expected to become more active or to be focused on managing the instrument, including the instrument becoming more closely monitored or controlled, or the entity specifically intervening with the borrower.

(p) past due information, including the rebuttable presumption as set out in paragraph 5.5.11.

Appendix B

IFRS 9 Implementation Guidance: Example 6—comparison to maximum initial credit risk

IE40 Bank A has two portfolios of automobile loans with similar terms and conditions in Region W. Bank A's policy on financing decisions for each loan is based on an internal credit rating system that considers a customer's credit history, payment behaviour on other products with Bank A and other factors, and assigns an internal credit risk rating from 1 (lowest credit risk) to 10 (highest credit risk) to each loan on origination. The risk of a default occurring increases exponentially as the credit risk rating deteriorates so, for example, the difference between credit risk rating grades 1 and 2 is smaller than the difference between credit risk rating grades 2 and 3. Loans in Portfolio 1 were only offered to existing customers with a similar internal credit risk rating and at initial recognition all loans were rated 3 or 4 on the internal rating scale. Bank A determines that the maximum initial credit risk rating at initial recognition it would accept for Portfolio 1 is an internal rating of 4. Loans in Portfolio 2 were offered to customers that responded to an advertisement for automobile loans and the internal credit risk ratings of these customers range between 4 and 7 on the internal rating scale. Bank A never originates an automobile loan with an internal credit risk rating worse than 7 (ie with an internal rating of 8–10).

IE41 For the purposes of assessing whether there have been significant increases in credit risk, Bank A determines that all loans in Portfolio 1 had a similar initial credit risk. It determines that given the risk of default reflected in its internal risk rating grades, a change in internal rating from 3 to 4 would not represent a significant increase in credit risk but that there has been a significant increase in credit risk on any loan in this portfolio that has an internal rating worse than 5. This means that Bank A does not have to know the initial credit rating of each loan in the portfolio to assess the change in credit risk since initial recognition. It only has to determine whether the credit risk is worse than 5 at the

reporting date to determine whether lifetime expected credit losses should be recognised in accordance with paragraph 5.5.3 of IFRS 9.

IE42 However, determining the maximum initial credit risk accepted at initial recognition for Portfolio 2 at an internal credit risk rating of 7, would not meet the objective of the requirements as stated in paragraph 5.5.4 of IFRS 9. This is because Bank A determines that significant increases in credit risk arise not only when credit risk increases above the level at which an entity would originate new financial assets (ie when the internal rating is worse than 7). Although Bank A never originates an automobile loan with an internal credit rating worse than 7, the initial credit risk on loans in Portfolio 2 is not of sufficiently similar credit risk at initial recognition to apply the approach used for Portfolio 1. This means that Bank A cannot simply compare the credit risk at the reporting date with the lowest credit quality at initial recognition (for example, by comparing the internal credit risk rating of loans in Portfolio 2 with an internal credit risk rating of 7) to determine whether credit risk has increased significantly because the initial credit quality of loans in the portfolio is too diverse. For example, if a loan initially had a credit risk rating of 4 the credit risk on the loan may have increased significantly if its internal credit risk rating changes to 6.

Appendix C

IFRS 9 Implementation Guidance: Example 1—significant increase in credit risk

IE7 Company Y has a funding structure that includes a senior secured loan facility with different tranches. Bank X provides a tranche of that loan facility to Company Y. At the time of origination of the loan by Bank X, although Company Y's leverage was relatively high compared with other issuers with similar credit risk, it was expected that Company Y would be able to meet the covenants for the life of the instrument. In addition, the generation of revenue and cash flow was expected to be stable in Company Y's industry over the term of the senior facility. However, there was some business risk related to the ability to grow gross margins within its existing businesses.

IE8 At initial recognition, because of the considerations outlined in paragraph IE7, Bank X considers that despite the level of credit risk at initial recognition, the loan is not an originated credit-impaired loan because it does not meet the definition of a credit-impaired financial asset in Appendix A of IFRS 9.

IE9 Subsequent to initial recognition, macroeconomic changes have had a negative effect on total sales volume and Company Y has underperformed on its business plan for revenue generation and net cash flow generation. Although spending on inventory has increased, anticipated sales have not materialised. To increase liquidity, Company Y has drawn down more on a separate revolving credit facility, thereby increasing its leverage ratio. Consequently, Company Y is now close to breaching its covenants on the senior secured loan facility with Bank X.

IE10 Bank X makes an overall assessment of the credit risk on the loan to Company Y at the reporting date by taking into consideration all reasonable and supportable information that is available without undue cost or effort and that is

relevant for assessing the extent of the increase in credit risk since initial recognition. This may include factors such as:

- (a) Bank X's expectation that the deterioration in the macroeconomic environment may continue in the near future, which is expected to have a further negative impact on Company Y's ability to generate cash flows and to deleverage.
- (b) Company Y is closer to breaching its covenants, which may result in a need to restructure the loan or reset the covenants.
- (c) Bank X's assessment that the trading prices for Company Y's bonds have decreased and that the credit margin on newly originated loans have increased reflecting the increase in credit risk, and that these changes are not explained by changes in the market environment (for example, benchmark interest rates have remained unchanged). A further comparison with the pricing of Company Y's peers shows that reductions in the price of Company Y's bonds and increases in credit margin on its loans have probably been caused by company-specific factors.
- (d) Bank X has reassessed its internal risk grading of the loan on the basis of the information that it has available to reflect the increase in credit risk.

IE11 Bank X determines that there has been a significant increase in credit risk since initial recognition of the loan in accordance with paragraph 5.5.3 of IFRS 9. Consequently, Bank X recognises lifetime expected credit losses on its senior secured loan to Company Y. Even if Bank X has not yet changed the internal risk grading of the loan it could still reach this conclusion—the absence or presence of a change in risk grading in itself is not determinative of whether credit risk has increased significantly since initial recognition.