

STAFF PAPER

16 September 2015

Project	Transition Resource Group for Impairment of Financial Instruments		
Paper topic	Use of changes in the risk of a default occurring over the next 12 months when assessing for significant increases in credit risk		
CONTACT(S)	Bernadette Whittick Kumar Dasgupta	bwhittick@ifrs.org kdasgupta@ifrs.org	+44 (0)20 7246 0552 +44 (0)20 7246 6902

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 an issue raised by a submitter regarding the use of changes in the risk of a default occurring over the next 12 months as an approximation of the changes in the lifetime risk of a default occurring when assessing for changes in credit risk in accordance with the impairment requirements of IFRS 9 *Financial Instruments* (2014). Specifically, the submitter asks 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.
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. Paragraph 5.5.4 of IFRS 9 sets out the objective of the impairment requirements and notes that an entity must consider all reasonable and supportable information, including information that is forward-looking, when making the assessment of significant increases in credit risk:

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.**
[emphasis added]

4. Furthermore, when making the assessment of significant increases in credit risk, paragraph 5.5.9 of IFRS 9 notes that an entity is required to use the change in the risk of default occurring over the expected life of the financial instrument:

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. Notwithstanding the above requirement to consider the lifetime risk of default, IFRS 9 also acknowledges that in certain circumstances, changes in the risk of a

ITG | Use of changes in the risk of a default occurring over the next 12 months when assessing for significant increases in credit risk

default occurring over the next 12 months may be a reasonable approximation of the changes in the lifetime risk of a default occurring. Specifically paragraphs B5.5.13 and B5.5.14 of IFRS 9 note:

B5.5.13 The methods used to determine whether credit risk has increased significantly on a financial instrument since initial recognition should consider the characteristics of the financial instrument (or group of financial instruments) and the default patterns in the past for comparable financial instruments. Despite the requirement in paragraph 5.5.9, for financial instruments for which default patterns are not concentrated at a specific point during the expected life of the financial instrument, changes in the risk of a default occurring over the next 12 months may be a reasonable approximation of the changes in the lifetime risk of a default occurring. **In such cases, an entity may use changes in the risk of a default occurring over the next 12 months to determine whether credit risk has increased significantly since initial recognition, unless circumstances indicate that a lifetime assessment is necessary.**

B5.5.14 However, **for some financial instruments, or in some circumstances, it may not be appropriate to use changes in the risk of a default occurring over the next 12 months to determine whether lifetime expected credit losses should be recognised.** For example, the change in the risk of a default occurring in the next 12 months may not be a suitable basis for determining whether credit risk has increased on a financial instrument with a maturity of more than 12 months when:

- (a) the financial instrument only has significant payment obligations beyond the next 12 months;

(b) changes in relevant macroeconomic or other credit-related factors occur that are not adequately reflected in the risk of a default occurring in the next 12 months; or

(c) changes in credit-related factors only have an impact on the credit risk of the financial instrument (or have a more pronounced effect) beyond 12 months. *[emphasis added]*

6. Illustrative Example 8 of IFRS 9 goes on to provide an example of a 10-year amortising loan, where an entity has determined that the 12-month risk of default is an appropriate approximation for the lifetime risk of default. This example is reproduced in full in Appendix A.
7. The guidance in paragraphs B5.5.13-B5.5.14 of IFRS 9 was originally considered in the 2013 *Impairment*, Exposure Draft, which proposed that a 12-month measure could be used ‘if the information considered did not suggest that the outcome would differ’. However, a number of respondents raised concerns about this wording, noting that it would essentially require an entity to compare the outcome from a 12-month assessment and prove that it would not differ from the outcome of a lifetime assessment.
8. In response to this feedback, the IASB reconfirmed that ideally an entity should use changes in the lifetime risk of a default occurring to assess changes in credit risk since initial recognition but observed that a 12-month measure of the risk of a default occurring may be an appropriate approximation in some circumstances. In order to assist entities in determining whether a 12-month assessment was suitable, the IASB included examples in paragraph B5.5.14 of IFRS 9 of when a 12-month assessment would not be appropriate, such as for specific types of financial instrument and in specific macroeconomic and credit-related circumstances. Furthermore, the IASB replaced the wording ‘if the information considered did not suggest that the outcome would differ’ with ‘unless circumstances indicate that a lifetime assessment is necessary’ in the final text of paragraph B5.5.13 of IFRS 9.

9. Paragraphs BC5.176- BC5.179 of IFRS 9 summarise the IASB's redeliberations on this matter:

BC5.176 The 2013 Impairment Exposure Draft required the determination of an increase in credit risk to be based on changes in the risk of a default occurring over the life of a financial instrument but noted that a 12-month measure could be used "if the information considered did not suggest that the outcome would differ".

BC5.177 Many respondents to the 2013 Impairment Exposure Draft noted that the assessment of significant increases in credit risk could be made more operational by aligning it with credit risk management practices, including enabling the use of a 12-month instead of lifetime risk of a default occurring when assessing changes in credit risk. **Many of these respondents were however concerned that the 2013 Impairment Exposure Draft would require entities to compare the outcome from a 12-month assessment and prove that it would not differ from the outcome of a lifetime assessment.**

BC5.178 In response to the feedback, the IASB noted that, ideally, an entity should use changes in the lifetime risk of a default occurring to assess changes in credit risk since initial recognition. However, **the IASB observed that changes in the risk of a default occurring within the next 12 months generally should be a reasonable approximation of changes in the risk of a default occurring over the remaining life of a financial instrument and thus would not be inconsistent with the requirements.** The IASB also noted that some entities use a 12-month probability of default measure for prudential regulatory requirements. These entities could therefore use their existing systems and methodologies as a starting point for determining significant increases in credit risk, thus reducing the costs of implementation.

BC5.179 However, the IASB noted that there may be circumstances in which the use of the risk of a default occurring within the next 12 months will not be appropriate. For example, this may be the case for financial instruments with a payment profile in which significant payment obligations occur beyond the next 12 months or when there are changes in macroeconomic or other credit-related factors that are not adequately reflected in the risk of a default occurring in the next 12 months. **Consequently, an entity may use changes in the risk of a default occurring within the next 12 months unless circumstances indicate that a lifetime assessment is necessary to meet the objective of identifying significant increases in credit risk since initial recognition.** *[emphasis added]*

10. Paragraph B5.5.16 of IFRS 9 acknowledges that credit risk analysis a multifactor and holistic analysis which needs to be tailored to the financial instruments being assessed. However, as noted in paragraph B5.5.12 of IFRS 9, while an entity may apply various approaches when assessing whether there has been a significant increase in credit risk, an entity must always consider the change in risk of default occurring since initial recognition, the expected life and all reasonable and supportable information 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.

11. Furthermore, as noted in paragraph BC5.157 of IFRS 9, the assessment of changes in credit risk does not require the use of a specific probability of default measure:

BC5.157 The IASB noted that it did not intend to prescribe a specific or mechanistic approach to assess changes in credit risk and that the appropriate approach will vary for different levels of sophistication of entities, the financial instrument and the availability of data. The IASB confirmed that the use of the term ‘probability of a default’ occurring was intended to capture the concept of the risk of a default occurring. **A specific probability of default measure is one way in which that could be assessed, but the IASB decided that it would not be appropriate to require particular sources of information to be used to make the assessment.** This is because credit analysis is a multifactor and holistic analysis, and when making that analysis entities have differences in the availability of data. Such differences include whether a specific factor is relevant, and its weight compared to other factors which will depend on the type of product, characteristics of the financial instrument and the customer as well as the geographical region. However, to reduce the risk of misinterpretation, the IASB decided to change the terminology from ‘probability of a default occurring’ to ‘risk of a default occurring’.

12. IFRS 7 requires an entity to disclose information regarding its credit risk management practices. Specifically, paragraphs 35F and 35G of IFRS 7 require

an explanation of how an entity has determined whether the credit risk of financial instruments has increased significantly since initial recognition and how forward-looking information (including macroeconomic information) has been incorporated into the determination of expected credit losses:

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 [.....]**

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**

[.....]

(b) **how forward-looking information has been incorporated into the determination of expected credit losses, including the use of macroeconomic information; and**

[.....]

Potential implementation issue identified

13. The submitter notes that in accordance with paragraphs B5.5.13 and B5.5.14 of IFRS 9, changes in the risk of a default occurring over the next 12 months may be a reasonable approximation of the changes in the lifetime risk of a default occurring for some financial instruments and in some types of circumstances. Furthermore, the submitter notes that this approach may be considered appropriate not only for short-term loans but also for long-term loans. The submitter notes that paragraph B5.5.14 specifically describes considerations for financial instruments with a maturity beyond 12 months. In addition, Illustrative Example 8 of IFRS 9 provides an example of a 10-year amortising loan for which the entity has determined that the 12-month probability of default is a reasonable approximation for the lifetime probability of default.
14. The submitter acknowledges that paragraph B5.5.13 of IFRS 9 includes a caveat about the use of a 12-month assessment, by noting that it may be used ‘unless circumstances indicate that a lifetime assessment is necessary’. However, the submitter also observes that, based on the discussions outlined in paragraphs BC5.176-BC5.179 of IFRS 9, it would appear that the IASB did not intend to require entities to compare the outcome from a 12-month assessment and prove that it would not differ from the outcome of a lifetime assessment.
15. Consequently, the submitter asks whether, and if so to what extent, an entity would be required to perform an annual review of whether the circumstances continued to support the use of an assessment of changes in the 12-month risk of default occurring as an approximation of a lifetime assessment.
16. The submitter presents an example of an entity that uses probability of default measures as a means of determining the risk of a default occurring. Initially, the entity considers that the 12-month probability of default is a reasonable approximation for the lifetime risk of a default occurring. In this context, the submitter questions the level of annual review required and proposes three alternative views:
 - (a) Quantitative Approach—the entity would be required to perform a quantitative annual review—ie because they are using a probability of

default based analysis, a lifetime probability of default would be calculated and compared with the 12-month probability of default.

(b) **Qualitative Approach**—the entity would continue to use the 12-month probability of default unless it became clear that changing macroeconomic and other credit related factors were not being taken into account in the 12-month probability of default, the effect of those factors was more pronounced beyond 12 months or if these factors only had an impact beyond 12 months. In other words, only a qualitative review would be required on an annual basis (essentially to assess changes in circumstances) but if that review suggested that the 12-month probability of default was no longer appropriate, then the entity would be required to change to an assessment considering the lifetime risk of default occurring such as by calculating a lifetime probability of default.

(c) **Recalibration Approach**—the entity would adjust the 12-month probability of default using a ‘top-down’ approach on an annual basis. In other words, it would identify the main macroeconomic and credit-related factors that would have the greatest impact on the appropriateness of the 12-month assessment and estimate the impact of these factors on the lifetime risk of default occurring. In this way, the entity could determine an appropriate adjustment to the 12-month probability of default such that it continued to be a reasonably proxy for a lifetime probability of default. The submitter suggests that such an approach could potentially allow the (adjusted) 12-month probability of default to continue to be a reasonable proxy for a lifetime probability of default.

17. The submitter considers that either a Quantitative or a Qualitative Approach would significantly diminish the usefulness of this practical expedient. The Quantitative Approach (as described by the submitter in paragraph 16(a) above) requires an entity to calculate lifetime probabilities of default on an annual basis and the Qualitative Approach (as described by the submitter in paragraph 16(b)

above) requires the entity to be able to produce lifetime probabilities of default if the annual review suggests that circumstances have changed. In the submitter's view this would seem contrary to the discussions in paragraphs BC5.176-BC5.179 of IFRS 9, which seem to imply that this level of proof is not required.

18. Consequently, the submitter asks whether an annual review of the circumstances supporting the use of a 12-month assessment as an approximation for a lifetime assessment is required by paragraph B5.5.13 of IFRS 9. Furthermore, if an annual review is required, the submitter asks whether any of the approaches outlined above would be considered appropriate or whether there are alternative ways of meeting the requirements.

Review of accounting requirements

19. The submitter uses a probability of default based analysis to describe the issue. However, we note that IFRS 9 does not require specific probability of default measures (12-month or lifetime) to be used to determine changes in credit risk (see paragraph BC5.157 of IFRS 9). Various approaches can be used in order to make this assessment depending on the level of sophistication of entities, the financial instrument being assessed and the availability of data. A probability of default measure is only one possible approach which may be used.
20. 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 using all reasonable and supportable information including that which is forward-looking. Furthermore, we observe that significant increases in credit risk must be assessed by considering changes in the risk of default occurring over the expected life of a financial instrument.
21. We also note that IFRS 9 acknowledges that credit risk analysis is a multifactor and holistic analysis which needs to be tailored to the financial instruments being assessed. Consequently and consistent with the overall approach in IFRS 9, the Standard does not prescribe specific techniques or methods to be used when assessing significant increases in credit risk. However, we observe that while an

entity may apply various approaches, in accordance with paragraph B5.5.12 of IFRS 9, an entity must always consider the change in risk of default occurring since initial recognition, the expected life and all reasonable and supportable information that may affect credit risk.

22. Despite the requirement in paragraph 5.5.9 of IFRS 9 to consider changes in the risk of default occurring over the expected life of a financial instrument, we note that in accordance with paragraphs B5.5.13 and B5.5.14 of IFRS 9, changes in the risk of a default occurring over the next 12 months may be used when they provide a reasonable approximation of the changes in the lifetime risk of a default occurring for some types of financial instruments and in some types of circumstances.
23. In this regard, we observe that paragraph B5.5.14 provides specific examples of when a 12-month assessment would not be appropriate, such as for specific types of financial instrument and in specific macroeconomic and credit-related circumstances. For example, an entity might originate a 10-year amortising loan and based on the nature of the instrument and the entity's view on the current and future macro-economic environment and other credit related factors, it may consider that a 12-month measure of the risk of default occurring is a reasonable approximation for the lifetime risk of a default occurring. If however, the entity's view of the future macro-economic environment or other credit-related factors changed such that the entity no longer considered that they were adequately reflected in the risk of a default occurring in the next 12 months, then a 12-month measure would no longer be an appropriate approximation of the lifetime risk of a default occurring. Consequently at this point, the entity would be required to assess credit risk based on changes in the lifetime risk of a default occurring.
24. We observe that this is consistent with paragraph BC5.179 of IFRS 9 which notes that an entity may use changes in the risk of a default occurring within the next 12 months unless circumstances indicate that a lifetime assessment is necessary to meet the objective of identifying significant increases in credit risk since initial recognition.

25. However, as noted in paragraph 21, IFRS 9 does not prescribe a specific approach to be used when assessing significant increases in credit risk. Similarly, we note that the Standard does not require a particular approach to be taken in order to determine whether a 12-month assessment continues to be appropriate. It merely notes that circumstances, such as those noted in paragraph B5.5.14 of IFRS 9, must not indicate that a lifetime assessment is necessary.
26. Based on the guidance above, we observe that an entity would need to be mindful of the basis upon which they originally concluded that a 12-month assessment was appropriate and where circumstances indicate that this original conclusion may be called into question, an entity would need to reconsider accordingly. Furthermore, we note that where an entity concludes that a 12-month assessment is no longer appropriate, then in order to comply with the requirements of paragraph 5.5.9 of IFRS 9, it must assess changes in credit risk in a manner that captures changes in risk of a default occurring over the expected life. Therefore, if it is concluded that a 12-month assessment is no longer appropriate, the Recalibration Approach (as described by the submitter in paragraph 16(c)) would need to capture changes in the risk of a default occurring over the expected life.
27. Furthermore, we note that an entity would be required to disclose how it has made the assessment of significant increases in credit risk and how forward-looking information (including macroeconomic information) has been incorporated into the determination of expected credit losses in accordance with paragraphs 35F and 35G of IFRS 7.

Question for ITG members

What are your views on the issue presented above?

Appendix A

A1. Example 8—12-month expected credit loss measurement using an explicit ‘probability of default’ approach

IE49 Entity A originates a single 10 year amortising loan for CU1 million. Taking into consideration the expectations for instruments with similar credit risk (using reasonable and supportable information that is available without undue cost or effort), the credit risk of the borrower, and the economic outlook for the next 12 months, Entity A estimates that the loan at initial recognition has a probability of default (PD) of 0.5 per cent over the next 12 months. Entity A also determines that changes in the 12-month PD are a reasonable approximation of the changes in the lifetime PD for determining whether there has been a significant increase in credit risk since initial recognition.

IE50 At the reporting date (which is before payment on the loan is due¹), there has been no change in the 12-month PD and Entity A determines that there was no significant increase in credit risk since initial recognition. Entity A determines that 25 per cent of the gross carrying amount will be lost if the loan defaults (ie the LGD is 25 per cent).² Entity A measures the loss allowance at an amount equal to 12-month expected credit losses using the 12-month PD of 0.5 per cent. Implicit in that calculation is the 99.5 per cent probability that there is no default. At the reporting date the loss allowance for the 12 month expected credit losses is CU1,250 (0.5% × 25% × CU1,000,000).

¹ Thus for simplicity of illustration it is assumed there is no amortisation of the loan.

² Because the LGD represents a percentage of the present value of the gross carrying amount, this example does not illustrate the time value of money.