

## STAFF PAPER

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<b>Project</b>	<b>Transition Resource Group for Impairment of Financial Instruments</b>		
<b>Paper topic</b>	Measurement of expected credit losses for revolving credit facilities		
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## Introduction

1. This paper addresses an issue raised by a submitter regarding the application of the impairment requirements of IFRS 9 *Financial Instruments* (2014) to a portfolio of revolving credit facilities. The issue relates to how an entity should estimate future drawdowns on undrawn lines of credit when an entity has a history of allowing customers to exceed their contractually set credit limits on their overdrafts and other revolving credit facilities.
2. This paper:
  - (a) sets out the relevant accounting requirements in IFRS 9;
  - (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 B5.5.28 of IFRS 9 states that expected credit losses are a probability-weighted estimate of credit losses (ie the present value of all cash shortfalls) over the expected life of the financial instrument. IFRS 9 defines credit losses as follows:

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

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

**B5.5.30** For undrawn loan commitments, a credit loss is the present value of the difference between:

(a) the **contractual cash flows that are due to the entity if the holder of the loan commitment draws down the loan**; and

(b) the cash flows that the entity expects to receive if the loan is drawn down *[emphasis added]*

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

**B5.5.31** An entity's estimate of expected credit losses on loan commitments shall be consistent with its expectations of drawdowns on that loan commitment, ie it shall consider the expected portion of the loan commitment that will be

drawn down within 12 months of the reporting date when estimating 12-month expected credit losses, and the expected portion of the loan commitment that will be drawn down over the expected life of the loan commitment when estimating lifetime expected credit losses.

6. Paragraph 5.5.19 of IFRS 9 stipulates that the maximum period to consider when measuring expected credit losses is the maximum contractual period (including extension options) over which the entity is exposed to credit risk and not a longer period, even if that period is consistent with business practice. However, paragraph 5.5.20 of IFRS 9 provides one exception to this requirement:

**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.

7. As outlined in paragraphs BC5.254–BC5.261 of IFRS 9, the reason behind this exception relates to concerns raised by respondents to the 2013 Impairment Exposure Draft in relation to the period to be considered for measuring expected credit losses for specific financial instruments:

**BC5.255** Respondents noted that the **use of the contractual period was of particular concern for some types of loan commitments that are managed on a collective basis**, and for which an entity usually has no practical ability to withdraw the commitment before a loss event occurs and to limit the exposure to credit losses to

the contractual period over which it is committed to extend the credit. Respondents noted that this applies particularly to revolving credit facilities such as credit cards and overdraft facilities. For these types of facilities, estimating the expected credit losses over the behavioural life of the instruments was viewed as more faithfully representing their exposure to credit risk. *[emphasis added]*

### **Potential implementation issue identified**

8. The submitter observes that in practice, the contractual credit limit on revolving facilities such as credit cards and, more commonly, bank overdrafts is often exceeded when the customer reaches default. If drawdowns in excess of the maximum contractual credit limit are not considered when estimating the exposure at default for the purpose of measuring expected credit losses, the submitter considers that a crucial element of the behaviour-based exposure would be excluded from the estimate of expected credit losses.
9. The submitter notes that paragraph 5.5.20 of IFRS 9 already sets out an exception for some types of revolving credit facilities regarding the extension of the appropriate period to consider when measuring expected credit losses, but the submitter also observes that there is no such specific guidance regarding extending the contractual credit limit to an amount in excess of that limit.
10. However, the submitter also notes that in respect of the undrawn element of a revolving credit facility, an entity is required to estimate the expected drawdowns in order to determine the contractual cash flows that would be due to the entity if the holder were to draw down. Specifically, paragraph B5.5.31 states that ‘an entity’s estimate of expected credit losses on loan commitments shall be consistent with its expectations of drawdowns on that loan commitment...’. The submitter points out that this guidance does not explicitly stipulate that an entity should only consider estimates within the contractual credit limits.

11. Consequently, the submitter asks whether an exposure in excess of the contractually agreed credit limit should be used when estimating the exposure at default for the purpose of measuring expected credit losses for revolving facilities that are within the scope of paragraph 5.5.20 of IFRS 9 and where an entity has a history of allowing customers to exceed their contractually set credit limits.

### **Review of accounting requirements**

12. The definition of credit losses set out in IFRS 9 states that they are the difference between contractual cash flows that are due to an entity and the cash flows that the entity expects to receive. Consequently, an entity is not permitted to consider cash flows outside of the contractual terms of the financial instrument unless a more specific exception applies.
13. Paragraphs B5.5.30–B5.5.31 of IFRS 9 provide further application guidance in respect of credit losses on loan commitments, which applies equally to the undrawn element of revolving credit facilities meeting the criteria set out in paragraph 5.5.20 of IFRS 9 and other stand-alone loan commitments. This application guidance notes that because the contractual cash flows due to the entity are not known at the reporting date, an entity is required to estimate expected drawdowns that a holder might make and also clarifies the appropriate period over which those drawdowns should be estimated.
14. We note that while paragraph B5.5.31 of IFRS 9 does not specifically refer to the contractual terms, it forms part of the application guidance in respect of the measurement of expected credit losses for undrawn loan commitments. As noted in paragraph 12 above, credit losses are defined as being the difference between the contractual cash flows that are due to an entity and the cash flows that the entity expects to receive. Consequently, estimations of drawdowns should be made in the context of the contractual terms of the loan commitment unless a more specific piece of guidance applies.

15. The exception outlined in paragraph 5.5.20 of IFRS 9 relates to the contractual commitment period and does not address the contractual credit limit. The corresponding paragraphs in the Basis for Conclusions of IFRS 9 (BC5.254-BC5.261) provide further background behind this exception and explain that it was in response to concerns raised by respondents regarding the appropriate period over which to measure expected credit losses for specific financial instruments. We note that respondents did not raise any concerns regarding the use of the contractual credit limit when measuring expected credit losses. It would not be appropriate to analogise the specific exception outlined in paragraph 5.5.20 of IFRS 9 relating to the contractual commitment period to the contractual credit limit.

**Question for ITG members**

What are your views on the issue presented above?