

STAFF PAPER

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Project	Transition Resource Group for Impairment of Financial Instruments		
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CONTACT(S)	Hannah King	hking@ifrs.org	+44 (0)20 7246 6961
	Kumar Dasgupta	kdasgupta@ifrs.org	+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 Transition Resource Group for Impairment of Financial Instruments. It does not represent the views of the IASB or any individual members of either the IASB or staff. Comments on the application of IFRSs do not purport to set out acceptable or unacceptable application of IFRSs.

Introduction

1. We have received two submissions about the use of forward-looking information in determining significant increases in credit risk of a financial asset and on measuring expected credit losses. The submitters are asking:
 - (a) whether forward-looking information should be incorporated into impairment reviews differently; for example, on a portfolio by portfolio basis and/or on an entity basis (for macroeconomic information) (Issue 1); and
 - (b) how to determine what is ‘reasonable and supportable’ forward-looking information about emerging issues and uncertain future events to include in the measurement of expected credit losses (Issue 2)?
2. With respect to Issue 2, the submitter observes that forward-looking information could include information about emerging issues and uncertain future events that is not taken into account in an entity’s current budgeting and forecasting processes. The submitter asks for comments on a proposed structured approach to help determine what forward-looking information should be considered in an assessment of expected credit losses.

3. This paper:
- (a) sets out the relevant accounting requirements in IFRS 9 *Financial Instruments* (2014), IFRS 7 *Financial Instruments: Disclosures* and IAS 1 *Presentation of Financial Statements*;
 - (b) summarises the potential implementation issues raised by the submitters; and
 - (c) asks the members of the Transition Resource Group for Impairment of Financial Instruments ('the ITG') for their views on the issues identified.

Accounting requirements

4. As stated in paragraph 5.5.4 of IFRS 9, 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 a collective basis—considering all reasonable and supportable information, including such information that is forward-looking.
5. An entity is required to take into account reasonable and supportable information that is available without undue cost or effort when determining whether credit risk has increased significantly since initial recognition (IFRS 9 paragraph B5.5.15). In addition, paragraph 5.5.17 requires:

5.5.17 ...an entity to measure expected credit losses of a financial instrument in a way that reflects:

...

- (c) reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions.

6. Specifically, as discussed below, the Standard refers to using:
- (a) reasonable and supportable information (paragraphs 8-12); and

(b) information relevant for the financial instrument being assessed (paragraphs 13-16).

7. Finally, the relevant disclosure requirements are summarised in paragraphs 17-18.

Reasonable and supportable information

8. Guidance about what is meant by ‘reasonable and supportable information’ is provided in paragraphs B5.5.49-B5.5.54 of IFRS 9.

9. Paragraph B5.5.49 of IFRS 9 clarifies that reasonable and supportable information is that which is reasonably available at the reporting date without undue cost or effort, including information about forecasts of future economic conditions. Paragraph B5.5.51 highlights that an entity need not undertake an exhaustive search for information, but shall use all such information that is relevant to the estimate of expected credit losses.

10. In addition, paragraph B5.5.51 indicates that information may be from a variety of sources:

B5.5.51 ...The information used shall include factors that are specific to the borrower, general economic conditions and an assessment of both the current as well as the forecast direction of conditions at the reporting date. An entity may use various sources of data, that may be both internal (entity-specific) and external. Possible data sources include internal historical credit loss experience, internal ratings, credit loss experience of other entities and external ratings, reports and statistics. Entities that have no, or insufficient, sources of entity-specific data may use peer group experience for the comparable financial instrument (or groups of financial instruments).

11. Paragraph B5.5.54 highlights that an entity should also consider observable market information, even though expected credit losses reflect an entity’s *own* expectations of credit losses. Consistent with this is the need for judgement, as noted in paragraph B5.5.50:

B5.5.50 ...The degree of judgement that is required to estimate expected credit losses depends on the availability of detailed information. ...

12. In addition the guidance notes, in paragraph B5.5.52, that:

B5.5.52 Historical information is an important anchor or base from which to measure expected credit losses. However, an entity shall adjust historical data, such as credit loss experience, on the basis of current observable data to reflect the effects of the current conditions and its forecasts of future conditions that did not affect the period on which the historical data is based, and to remove the effects of the conditions in the historical period that are not relevant to the future contractual cash flows. In some cases, the best reasonable and supportable information could be the unadjusted historical information, depending on the nature of the historical information and when it was calculated, compared to circumstances at the reporting date and the characteristics of the financial instrument being considered. Estimates of changes in expected credit losses should reflect, and be directionally consistent with, changes in related observable data from period to period (such as changes in unemployment rates, property prices, commodity prices, payment status or other factors that are indicative of credit losses on the financial instrument or in the group of financial instruments and in the magnitude of those changes). An entity shall regularly review the methodology and assumptions used for estimating expected credit losses to reduce any differences between estimates and actual credit loss experience.

Relevant information

13. Paragraph B5.5.16 of IFRS 9 notes that an entity shall consider reasonable and supportable information that is available without undue cost or effort and that is *relevant for the particular financial instrument* being assessed.

14. Paragraph B5.5.16 further notes that 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. If factors or indicators are not identifiable on an individual financial instrument level, they should be assessed for appropriate portfolios, groups of portfolios or portions of a portfolio of financial instruments.¹ As noted in paragraph B5.5.5, financial instruments can be grouped on the basis of shared credit risk characteristics for the purposes of a collective assessment of impairment.
15. Example 5—*responsiveness to changes in credit risk* to IFRS 9 contains an example of a bank with mortgage loans within a region that contains a mining community and thus is largely dependent on the export of coal and related products. In paragraph IE38, the example illustrates that, in this specific case, relevant information includes a significant decline in coal exports, the consequent anticipated closure of several mines and thus an expected increase in the unemployment figures within the mining industry in that region. The example notes that because of the expected increase in the unemployment rate, the risk of a default occurring on mortgage loans to borrowers who are employed by the coal mines is determined to have increased significantly, even if those customers are not past due at the reporting date. Furthermore, the example highlights that the bank segments its mortgage portfolio by the industry within which customers are employed, to identify customers that rely on coal mining as the dominant source of employment, as a means to identify a sub-portfolio with a common risk characteristic.
16. Paragraph B5.5.18 of IFRS 9 discusses whether information needs to flow through a statistical model or credit ratings process to determine whether there has been a significant increase in credit risk since initial recognition:

¹ Examples of information that may be relevant in assessing changes in credit risk are given in paragraph B5.5.17 of IFRS 9.

B5.5.18 In some cases, the qualitative and non-statistical quantitative information available may be sufficient to determine that a financial instrument has met the criterion for the recognition of a loss allowance at an amount equal to lifetime expected credit losses. That is, the information does not need to flow through a statistical model or credit ratings process in order to determine whether there has been a significant increase in the credit risk of the financial instrument. In other cases, an entity may need to consider other information, including information from its statistical models or credit ratings processes. Alternatively, the entity may base the assessment on both types of information, ie qualitative factors that are not captured through the internal ratings process and a specific internal rating category at the reporting date, taking into consideration the credit risk characteristics at initial recognition, if both types of information are relevant.

Disclosures

17. IFRS 9 amends IFRS 7 to expand disclosures about credit risk, with the objective of ensuring that an entity's credit risk disclosures should enable users of the financial statements to understand the effect of credit risk on the amount, timing and uncertainty of future cash flows (paragraph 35B of IFRS 7). Specifically, paragraph 35G(b) requires an entity to disclose how forward-looking information has been incorporated into the determination of expected credit losses, including the use of macroeconomic information.
18. In addition, paragraphs 125-133 of IAS 1 require an entity to disclose information about the assumptions it makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

Issue 1–Differentiating forward-looking information

Potential implementation issue identified

19. The first submission asks whether forward-looking information (eg indicators, forecasts of future economic conditions and scenarios) should be incorporated in the determination of expected credit losses in a differentiated way, for example country by country, bank by bank and portfolio by portfolio.
20. The submitter puts forward two examples:
 - (a) A forward-looking indicator, such as an unemployment rate, may have different effects on different retail portfolios depending on the nature of those portfolios. For example, in some jurisdictions, a mortgage portfolio with low loan-to-value ratios may be relatively insensitive to an increase of the unemployment rate, compared to a revolving credit card portfolio.
 - (b) At a macroeconomic level, the conditions set by central banks to control their monetary policy (eg interest rates, quantitative easing) apply uniformly to all financial institutions within their jurisdiction. However, while banks have access to the same liquidity offered by the central bank, the allocation of this liquidity may vary from one financial institution to another, and hence the same macroeconomic event may affect banks differently.
21. The submitter points out that for retail businesses, using a prescriptive set of indicators and/or identical scenarios will not appropriately reflect the credit risk of each banking institution or specific portfolios. The submitter concludes that, accordingly, forward-looking indicators and scenarios should be weighted and considered differently by entities and by portfolio to more appropriately measure expected credit losses.

Review of accounting requirements

22. We note that the Standard requires that impairment assessments:

- (a) are performed on individual financial instruments or collectively on groups of financial instruments that *share common credit risk characteristics* (see paragraph 14); and
 - (b) consider reasonable and supportable information, including forward-looking information, that is *relevant* for the particular financial instrument or group of financial instruments being assessed (see paragraphs 13-16).
23. Hence information, including forward-looking information, that is relevant for the assessment of one financial instrument or a group of financial instruments with common credit risk characteristics, may not be relevant, or as relevant, for the assessment of other financial instrument(s). Accordingly, it is necessary to determine which information is relevant to the particular financial instrument(s) being assessed and how much weight to give to that information.
24. This is clarified in paragraph B5.5.16 of IFRS 9, which states that whether forward-looking information 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 (see paragraph 14). As noted in paragraph 11, this will require the use of judgement.
25. In addition, Example 5 to IFRS 9 gives an example of how expectations about future levels of unemployment in a specific industry and specific region are only relevant to a sub-portfolio of mortgage loans in which the borrower works in that industry in that specific region (see paragraph 15). Hence, that specific information would only be relevant for the impairment assessment of that sub-portfolio.
26. However, some information may be relevant to more than one instrument or group of financial instruments (eg forecast increases in LIBOR may be relevant, although possibly not to the same extent, to both mortgage portfolios and corporate loans with variable interest rates benchmarked to LIBOR).
27. In addition, as noted in paragraph 12, paragraph B5.5.52 of IFRS 9 notes that estimates of changes in expected credit losses should reflect, and be directionally consistent with, changes in related observable data from period to period (and also

be consistent with the magnitude of those changes). Paragraph B5.5.52 of IFRS 9 also requires an entity to regularly review the methodology and assumptions used for estimating expected credit losses, to reduce any differences between estimates and actual credit loss experience.

Issue 2—Reasonable and supportable forward-looking information

Potential implementation issue identified

28. Issue 2 expands the scope of the question raised in Issue 1 and is about how to determine what forward-looking information to include in the IFRS 9 impairment assessment, as required in paragraphs 5.5.17(c) and B5.5.15 of IFRS 9.
29. The submitter notes that there are different sources of forward-looking information:
 - (a) macroeconomic assumptions and forecasts and other more detailed data that is currently used by an entity for budgeting and forecasting purposes, including consensus forecasts by third-party providers; and
 - (b) other forward-looking information on emerging issues and uncertain future events that are not usually included in the entity's current budgeting and forecasting processes.
30. The submitter comments that the forward-looking information used by an entity for budgeting and forecasting purposes, as mentioned in paragraph 29(a), would normally be subject to processes that enable it to be considered 'reasonable and supportable' information—for example, because correlations between this information and the probability of default for particular loans/portfolios have been appropriately established and incorporated within a core process. Hence, this information can be used to identify significant increases in credit risk and to measure expected credit losses. Such information does not generally include the impact of one-time uncertain future events or emerging issues.
31. However, the submitter notes that other forward-looking information mentioned in paragraph 29(b) about emerging issues and uncertain future events cannot, by its nature, be routinely factored into an entity's underlying risk models or

incorporated into the normal macroeconomic forecasts. Hence, the submitter asks how to determine when information about such emerging issues becomes ‘reasonable and supportable’ information that should be taken into account in the IFRS 9 impairment assessment.

32. The submitter gives two examples of forward-looking information of the type identified in paragraph 29(b):
- (a) In the period leading up to the date of the Scottish Referendum on 18 September 2014, there was uncertainty about whether the people of Scotland would vote for Scottish independence. During 2013, the Referendum was a known event due to happen in 2014. The submitter asserts that at December 2013 it was widely considered that the possibility of a ‘Yes’ majority vote, under which Scotland would leave the union with the rest of the UK, remained remote. However, by June 2014, the possibility of a ‘Yes’ outcome had increased significantly, such that, while still not generally considered likely, it was no longer remote.
 - (b) There is a possibility of a future Greek exit from the Eurozone, which increased significantly during the first half of 2015, although it is still uncertain at the date of the submission.
33. For uncertain future events, such as those mentioned above, there are often further economic consequences. For example, to determine the impact of a potential ‘Yes’ outcome in the Scottish Referendum on credit risk, it would be necessary to have more information about the consequences of a ‘Yes’ majority vote. Such information could include, for example: the timetable for change; what the financial arrangements would be for a separate Scottish currency; what aid might be forthcoming from the UK Government. However, information about these economic consequences may not be available at the reporting date.
34. In addition, the possible outcome of one uncertain future event may trigger other even more uncertain future events elsewhere. For example, if Greece did exit the Eurozone, there potentially could be knock-on consequences for some other

Eurozone countries, leading to uncertainties about their own continuation in the Eurozone.

35. The submitter notes that paragraph IE38 of Example 5 of IFRS 9 sets out an example of the impact of a fall in coal exports on a retail loan portfolio in an area where employment is dependent upon mining. The example indicates an approach that considers a macroeconomic variable that is identified (declining coal exports) and then considers the possible economic consequences (pit closures). Pit closures would result in increased unemployment, which has a known correlation with the probability of default.
36. The submitter asks what kind of information, with associated likelihoods, should be considered in a holistic assessment of expected credit losses. The submitter asks ‘For example, should this information be incorporated’ [into impairment assessments] ‘at the point that the issue becomes known but is still considered improbable? Or is it at the point that the issue is known, becomes more likely (though not yet probable) and that the correlation with a significant increase in credit risk and expected credit losses is appropriately established?’
37. The submitter notes that judgement is needed and that in their view there needs to be a balance between:
 - (a) excluding information and thus unnecessarily restricting the incorporation of forward-looking information in the determination of expected credit losses; and
 - (b) taking into account all views on future possibilities, including those of a speculative nature, regardless of their source or reliability, which may create a situation in which it is not possible to properly incorporate the impact of these events into the measurement of expected credit losses.
38. The submitter suggests that because of the uncertainty associated with a continually changing assessment of conditions and possible outcomes, a structured approach would be helpful in determining which information is

included in the determination of expected credit losses. The submitter proposes that a structured approach might involve the following elements²:

- (a) The preparer should obtain an analysis that identifies the significant drivers of credit risk and default for the loans being assessed (for example, correlations of macro-variables to probabilities of default and loss given default). Such an analysis would be likely to be included in a preparer's 'normal' risk modelling processes (as identified in paragraph 29(a)). The preparer should systematically apply these correlations to the forecast information obtained, for both individual and collective loans.
- (b) The preparer should additionally include lender specific knowledge about specific borrowers in the assessment of forward-looking information. For individually assessed loans, lenders are likely to have deeper information about the borrower that could impact credit risk.
- (c) The preparer should identify other emerging themes not included in steps (a)-(b) where experienced credit judgment indicates an impact on the risk of default and/or loss given default. The submitter proposes that the preparer should apply overlays to reflect this information at a collective level to affected portfolios, where a relationship can be established that is reasonable and supportable and the scenario is considered sufficiently likely. Such emerging themes are likely to be consistent with the risk factors identified in the annual report and accounts and could be of a macroeconomic nature specific to the preparer's business (eg political/economic upheaval; expected movements in petrol prices; expected growth in international trade links). Emerging issues may not yet be incorporated into a preparer's internal risk models in step (a) simply by virtue of timing.
- (d) In addition, the submitter proposes that the preparer should also consider material shock possibilities (such as those outlined in paragraph 32) that are not considered remote. The preparer should exercise judgement on whether, and how, to incorporate these shock events into the determination of expected credit losses based on the available information at the reporting date that is supportable and reasonable. This may depend upon the extent of, and information available about, consequential events resulting from potential outcomes of the initial shock event, as noted in paragraphs 33-34. Note that robust modelling constructed over a long time horizon may take into account more 'generic' shock and unknown events, which would not require separate consideration.

² This structured approach is as proposed by the submitter. The IASB has not discussed this approach and therefore it does not represent the views of the IASB.

(e) For material uncertainties that are not remote but could not be reliably quantified, appropriate disclosures should be considered.

39. The submitter asks for comments on the appropriateness of a structured approach such as that outlined above and whether there are any other considerations that may need to be taken into account.

Review of accounting requirements

40. In this section, we review the specific accounting guidance relevant to the issues raised by the submitter.
41. The submitter suggests a structured approach to help identify different sub-sets of information that are available to an entity in determining whether to take it into account in its impairment assessments. We note that there may be more than one approach that might meet the requirements of the Standard.
42. Paragraph B5.5.52 of IFRS 9 outlines a structured process to measure expected credit losses, starting with historical information as an anchor or base (see paragraph 12). The historical data is adjusted on the basis of current observable data to:
- (a) reflect the effects of current conditions and forecasts of future conditions that did not affect the period on which the historical data is based; and
 - (b) remove the effects of the conditions in the historical period that are not relevant to the future contractual cash flows.
43. We note that IFRS 9 requires that the information (including information about the related economic consequences) be '*reasonable and supportable*'. Insufficient information and data about a future event and its economic consequences may mean that it is not supportable. We observe that this may be more likely for one-time uncertain future events. One such example would be information about the impact of a possible majority vote for Scottish independence in the period leading up to the Scottish Referendum, discussed in paragraphs 32-33.

44. Reasonable and supportable information should be *relevant* to, and may affect the credit risk on, a particular instrument, portfolio or sub-portfolio of instruments being assessed, as discussed in Issue 1 (see paragraphs 22-27).
45. All reasonable and supportable information is considered in the assessment of significant increases in credit risk and the measurement of expected credit losses. We note that reasonable and supportable information may include information about future events for which there is a low likelihood of the event occurring. We also note that even if an event is remote it may still be relevant. Consistent with this, paragraph 5.5.18 of IFRS 9 states that when measuring expected credit losses, an entity should reflect the possibility that both a credit loss occurs and that no credit loss occurs, **even if the possibility of a credit loss occurring is very low**. Remoteness in and of itself is not a reason to conclude that information about an event should be excluded from the analysis. However, IFRS 9 also clarifies that an entity need not necessarily identify every possible scenario.
46. As noted in paragraph 11, the Standard highlights that determining expected credit losses is an estimate and that judgement is needed. The degree of judgement will depend upon the availability of detailed information. Judgement is needed to strike a balance between:
- (a) inappropriately excluding forward-looking information that is relevant; and
 - (b) including all views on future possibilities, including those of a speculative nature that have little or no basis.
47. We observe that IFRS 9 requires an entity to consider a variety of sources of information, including factors that are specific to the borrower (as suggested by the submitter in step (b) of the proposed approach in paragraph 38), general economic conditions (as suggested in steps (a), (c) and (d)) and an assessment of the current and forecast direction of conditions at the reporting date. The Standard also notes that possible data sources include internal historical credit loss experience, internal ratings, credit loss experience of other entities, external ratings, reports and statistics and other observable market information. (See paragraphs 10-11.)

48. Within the context of determining significant increases in credit risk, paragraph B5.5.18 notes that in some cases, available qualitative and non-statistical quantitative information may be sufficient. In other words, the information does not have to flow through a statistical model or credit rating process in order to determine whether there has been a significant increase in credit risk. However, in other cases an entity may need to consider other information, including information from its statistical models or credit rating processes. Alternatively, the entity may base its assessment on both types of information (ie qualitative factors that are not captured through the internal ratings process and a specific internal reporting category at the reporting date), if both types of information are relevant. (See paragraph 16.)
49. This means that reasonable and supportable information can encompass both information currently used by an entity for budgeting and forecasting purposes (as identified in paragraph 29(a)) and other forward-looking information on emerging issues and uncertain future events *that are not* usually included in the entity's current budgeting and forecasting processes (as identified in paragraph 29(b)). However, as noted by the submitter, it may be most appropriate to include such forward-looking information on emerging themes by way of overlays in order to reflect this information on a collective level to affected portfolios.
50. However as noted in paragraph 12, paragraph B5.5.52 of IFRS 9 highlights that estimates of changes in expected credit losses should reflect and be directionally consistent with changes in related observable data from period to period (and also be consistent with the magnitude of those changes).
51. As indicated in step (d), the Standard requires that an entity to regularly review the methodology and assumptions used for estimating expected credit losses to reduce any differences between estimates and actual credit loss experience. This requirement applies to all the methodologies and assumptions used. (See paragraph 12.)

Disclosure

52. The final step (step (e)) suggests that disclosure should be considered.

53. As noted in paragraph 17, paragraph 35G(b) of IFRS 7 requires an entity to disclose how forward-looking information has been incorporated into the determination of expected credit losses, including the use of macroeconomic information.
54. In this regard, we note that an entity should be mindful of achieving the overall objective of the credit risk disclosures in IFRS 7, ie to enable users of financial statements to understand the effect of credit risk on the amount, timing and uncertainty of future cash flows. Consequently, we would expect such disclosures to also provide an explanation of relevant information, including forward-looking information, that has been excluded from the measurement of expected credit losses.
55. In addition, IAS 1 requires an entity to disclose information about the assumptions it makes about the future and other major sources of estimation uncertainty at the end of the reporting period. (See paragraph 18.)

Question for ITG members

What are your views on the issues discussed in this paper?