

Transition Resource Group for Impairment of Financial Instruments

Meeting Summary–16 September 2015

Introduction

1. The Transition Resource Group for Impairment of Financial Instruments (ITG) met on 16 September 2015 at the IASB offices in London.
2. This note is prepared by the staff of the IASB and is a high level summary of the discussion that took place with ITG members. The agenda papers for the meeting and a full recording of the meeting are available on the [IASB website](#).
3. After introductory remarks from the Chair, ITG members considered issues in respect of the following aspects of the impairment requirements of IFRS 9 *Financial Instruments* (2014):
 - (a) significant increases in credit risk;
 - (b) use of changes in the risk of a default occurring over the next 12 months when assessing whether there has been a significant increase in credit risk;
 - (c) measurement of expected credit losses for revolving credit facilities; and
 - (d) forward-looking information.
4. In addition, a representative from the Basel Committee on Banking Supervision (BCBS) gave an update on the proposed BCBS guidance on accounting for expected credit losses.

Introductory remarks

5. The Chair welcomed members of the ITG to the second full meeting of the ITG and thanked them for their support and time commitment in participating in the group.
6. The Chair reminded ITG members about the purpose of ITG meetings. She emphasised that the ITG does not provide authoritative guidance. The IASB staff would provide a summary of the meeting, which will be made available on the IASB website. The Chair observed that the issues for discussion at the meeting met the objectives of the ITG, particularly its objective of assisting stakeholders in understanding the new impairment requirements from others involved in implementation.
7. The Chair noted that the ITG has a finite life, because at a certain point in time stability in the requirements will be necessary to avoid uncertainty, which might hinder or delay implementation. The next meeting of the ITG is scheduled for 11 December 2015, for which submissions should be made by 21 October. No further meetings have been scheduled or are planned, but this did not mean that the ITG would be wound up at the end of the year. Instead the group would remain in place and further meetings would be convened if circumstances warranted it.
8. The IASB Technical Director explained that, as noted on the Submissions Log, seven submissions had been received since the last meeting of the ITG, of which six were being discussed at this meeting. The staff were in discussions with the submitter about the outstanding submission and expect to bring the issue to the next ITG meeting.

9. The IASB Technical Director confirmed that the IASB would be kept informed of ITG discussions, but, at this stage, such an update was not expected to involve a technical discussion of the issues.
10. The IASB Technical Director highlighted that the agenda papers were prepared based on submitters' fact patterns and hence such fact patterns do not represent staff or IASB views.

Significant increases in credit risk (Agenda Paper 1)

11. Agenda Paper 1 addressed two issues relating to how an entity should make the assessment of significant increases in credit risk in accordance with the impairment requirements of IFRS 9. Specifically, the ITG considered:
 - (a) how an entity should determine whether there has been a significant increase in credit risk for a portfolio of loans advanced to customers across broad credit quality bands with identical pricing and contractual terms, for example, retail loans (Issue 1); and
 - (b) 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 (Issue 2).

Issue 1

12. The submitter presented an example of a retail loan portfolio (Portfolio A) comprising customers who had been assigned initial credit grades between 1 and 5 (based on a 10-grade rating scale where 1 is the highest credit quality) and had been issued loans with the same contractual terms and pricing. The submitter asked whether it would be appropriate to make the determination of significant increases in credit risk by using a single threshold approach such as that outlined for Portfolio 1 in Illustrative Example 6 of IFRS 9, on the basis that the exposures in Portfolio A could be considered to have a similar initial credit risk. Alternatively, the submitter asked whether there were other more appropriate approaches—for example defining a significant increase in credit risk as a specific number of notch increases in credit grade.
13. ITG members observed that the appropriateness of using a credit grading system will always depend on an entity's specific facts and circumstances. In particular, the answer to the submitter's question would depend upon the range of factors taken into account in determining individual credit grades, how the credit grading system operated and how it was related to the risk of a default occurring. However, ITG members noted that when assessing whether there has been a significant increase in credit risk, an entity should be mindful of achieving the objective of the impairment requirements, ie to recognise lifetime expected credit losses for all financial instruments for which there have been significant increases in credit risk since initial recognition. Consequently, ITG members observed that in accordance with IFRS 9:
 - (a) the impairment model is based on an assessment of changes in credit risk since initial recognition, rather than the identification of a specific level of credit risk at the reporting date; and
 - (b) a smaller absolute change in the risk of default occurring will be more significant for an asset that is of high quality on initial recognition than for one that is of low quality.
14. ITG members discussed Illustrative Example 6 in IFRS 9 and noted that in respect of Portfolio 1, the assessment of significant increases in credit risk was made using a form of absolute approach. However, it was pointed out that this approach was still consistent with the objective of identifying significant increases in credit risk since initial recognition. In particular, only loans with an initial credit grade of 3 or 4 were included in Portfolio 1 and furthermore, the entity had concluded that a movement from credit grade 3 to 4 did not represent a significant increase in credit risk. Consequently, ITG members observed that in

respect of Portfolio 1 in Example 6, using a single threshold of credit grade 5 as a means of identifying a significant increase in credit risk since initial recognition served to capture changes in credit risk in a manner that achieved the objective of the impairment requirements.

15. In contrast, ITG members noted that in the submitter's example, Portfolio A contained loans with initial credit grades ranging between 1 and 5. ITG members questioned whether such a broad range of credit grades could be considered to represent a similar initial credit risk and noted that in order to conclude that the assessment could be based on whether loans had a credit rating worse than 5, the entity would need to have determined that movements between credit grades 1 and 5 did not represent a significant increase in credit risk.
16. ITG members acknowledged that when assessing whether there has been a significant increase in credit risk, it would not be appropriate for the entity to consider only factors such as pricing and contractual terms. In this regard, it was noted that while the concept of economic loss was considered in developing the IFRS 9 model, the Standard requires an assessment of changes in credit risk based on a wide range of factors including internal and external indicators of credit risk, changes to contractual terms, actual and expected performance/behaviours and forecasts of future conditions
17. ITG members also discussed more generally the appropriateness of using internal credit grading systems as a means of assessing changes in credit risk since initial recognition. ITG members made the following observations relating to this point:
 - (a) credit grading systems were not designed with the requirements of IFRS 9 in mind and consequently, it should not be assumed that they will always be an appropriate means of identifying significant increases in credit risk. For example, an entity would need to consider whether the credit grades:
 - (i) were reviewed with sufficient frequency;
 - (ii) included all reasonable and supportable information, including information that is forward-looking; and
 - (iii) reflected the risk of default over the expected life of the financial instrument.
 - (b) credit grading systems vary and so care needs to be taken when referring to movements in credit grades and how this reflects an increased risk of default occurring; and
 - (c) the assessment of whether a change in credit risk grade represents a significant increase in credit risk in accordance with IFRS 9 depends on the initial credit risk of the financial instrument being assessed. Because the relationship between credit grades and changes in the risk of default occurring differs between credit grading systems (for example, in some cases the changes in the risk of a default occurring may increase exponentially between grades whereas in others it may not), this requires particular consideration.
18. In addition, it was noted by a number of ITG members that information available at an individual financial instrument level and/or built into a credit risk grading system may not incorporate forward-looking information as required by IFRS 9. Consequently, the assessment of significant increases in credit risk may need to be supplemented by a collective assessment to capture forward-looking information. However, it was noted that a collective assessment should not obscure significant increases in credit risk at an individual financial instrument level. In this regard, some ITG members commented on the importance of portfolio segmentation, noting that entities should ensure that sub-portfolios were not defined too widely.

Issue 2

19. The submitter asked whether some types of behavioural measures of credit risk (for example, if a customer has failed to make a payment on a facility with another lender) could serve as a reasonable proxy for identifying significant increases in credit risk since initial recognition.

The submitter also asked whether such behavioural measures could be used as a means of demonstrating that a financial instrument had a low credit risk in accordance with IFRS 9.

20. ITG members noted that in accordance with IFRS 9:
 - (a) an entity is required to assess whether there has been a significant increase in credit risk since initial recognition—ie the assessment is relative in nature;
 - (b) when assessing whether there has been a significant increase in credit risk since initial recognition, an entity shall use the change in the risk of a default occurring over the expected life of the financial instrument¹; and
 - (c) a significant increase in credit risk is expected to occur prior to delinquency and consequently, when making this assessment, an entity is required to consider all reasonable and supportable information, including information that is forward-looking, that is available without undue cost and effort.
21. ITG members noted that when assessing whether there has been a significant increase in credit risk, entities are required to consider a range of indicators rather than focussing on only one. Furthermore, it was noted that while behavioural indicators had a role to play, measures such as those presented by the submitter were often lagging indicators of increases in credit risk and consequently, they should be considered in conjunction with other, more forward-looking information. In this regard, ITG members noted that an entity must consider how to source and incorporate forward-looking information into the assessment of significant increases in credit risk and observed that an entity may need to do this on a collective basis if forward-looking information is not available at an individual financial instrument level.
22. When considering the use of behavioural indicators, it was noted that an entity should:
 - (a) focus on identifying pre-delinquency behavioural indicators of increases in credit risk, for example increased utilisation rates or increased cash drawings on specific products;
 - (b) only use indicators that are relevant to the risk of default occurring;
 - (c) establish a link between the behavioural indicators of credit risk and changes in the risk of default occurring since initial recognition;
 - (d) be mindful that while behavioural indicators are often predictive of defaults in the short term, they are often less predictive of defaults in the longer term; and
 - (e) consider whether the use of behavioural indicators is appropriate for the type of product being assessed—for example, if a loan has only back-ended payments, behavioural indicators based on timeliness of payment will not be appropriate.
23. ITG members discussed that an entity is required to consider all information available without undue cost and effort and observed that entities should not be limited by the information that is available internally—for example, an entity should consider using third-party information from sources such as credit bureaus. However, it was also acknowledged that the information available to entities will vary across jurisdictions.
24. A number of ITG members noted that when making the assessment of significant increases in credit risk, an entity should consider the possibility of segmenting the portfolio into groups of financial instruments with shared credit characteristics in such a way that similar indicators of credit risk could be used to identify increases in credit risk for specific sub-portfolios.
25. Regarding the question of whether behavioural indicators of credit risk such as those noted by the submitter could be used for the purposes of identifying low credit risk assets in accordance with paragraph 5.5.10 of IFRS 9, a number of ITG members commented that this would not be appropriate, on the basis that such measures would not constitute a globally accepted definition of low credit risk as required by IFRS 9.

¹ Subject to changes in the 12-month risk of default occurring being used as a proxy for changes in the lifetime risk of a default occurring when appropriate—see Agenda Paper 2 for a further discussion.

Use of changes in the risk of a default occurring over the next 12 months when assessing significant increases in credit risk (Agenda Paper 2)

26. Paragraphs B5.5.13-B5.5.14 of IFRS 9 acknowledge that when assessing whether a significant increase in credit risk has occurred, changes in the risk of a default occurring over the next 12 months may be a reasonable approximation of changes in the lifetime risk of a default occurring for some financial instruments and in some types of circumstances. The submitter asked whether, and if so to what extent, an entity would be required to perform a review to determine whether circumstances still support the use of changes in the 12-month risk of a default occurring as an approximation of changes in the lifetime risk of default occurring.
27. ITG members discussed that, in accordance with IFRS 9, an entity is required to assess changes in the risk of a default occurring over the expected life of a financial instrument when assessing whether a significant increase in credit risk has occurred. ITG members also noted that IFRS 9 acknowledges that changes in the 12-month risk of a default occurring may be an appropriate proxy for a lifetime assessment in cases in which expected default patterns are not concentrated at a specific point during the expected life of the financial instrument.
28. ITG members noted that they would expect an entity to complete a robust analysis up front in order to support the conclusion that changes in the 12-month risk of a default occurring were a reasonable approximation for the assessment of changes in the lifetime risk of default occurring.
29. Some ITG members commented that the level of initial analysis required would depend on the specific type of financial instrument being considered. Consequently in some cases, a qualitative analysis would suffice whereas in less clear-cut cases, a quantitative analysis may be necessary. It was also noted that it may be appropriate to segregate portfolios (for example by maturity) in order to facilitate the analysis for groups of similar financial instruments.
30. ITG members also discussed the level of ongoing review that would be required. They noted that an entity would need to be satisfied on an ongoing basis that the use of changes in the 12-month risk of a default occurring continued to be a reasonable approximation for changes in the lifetime risk of a default occurring.
31. ITG members also discussed the appropriate type of review that should be undertaken on an ongoing basis and observed that while a quantitative review would not necessarily be required, it would depend on the specific facts and circumstances. It was noted that one way of approaching an ongoing review would be as follows:
 - (a) identify the key factors that would affect the appropriateness of using changes in the 12-month risk of a default occurring as an approximation of changes in the lifetime risk of default occurring;
 - (b) monitor these factors on an ongoing basis as part of a qualitative review of circumstances; and
 - (c) consider whether any changes in those factors indicated that changes in the 12-month risk of a default occurring were no longer an appropriate proxy for changes in a lifetime risk of default occurring.
32. ITG members observed that if it were determined that changes in the 12-month risk of a default occurring were no longer a reasonable approximation for the assessment of changes in the lifetime risk of a default occurring, an entity would be required to determine an appropriate approach to capture changes in the lifetime risk of a default occurring.
33. A number of ITG members noted that it was important to emphasise that the guidance set out in paragraphs B5.5.13—B5.5.14 of IFRS 9, which permits an entity to use changes in the 12-month risk of a default occurring as an approximation for the lifetime risk of default occurring in certain cases, is only relevant for the assessment of significant increases in credit risk and does *not* relate to the measurement of expected credit losses. When an entity is

required to measure lifetime expected credit losses, that measurement must always reflect the lifetime risk of a default occurring.

34. ITG members also observed that IFRS 9 does not prescribe how an entity should determine whether the use of changes in the 12-month risk of a default occurring was an appropriate proxy for assessing changes in the lifetime risk of a default occurring. However, it was noted that entities are required to disclose how they make the assessment of significant increases in credit risk, in accordance with IFRS 7 *Financial Instruments: Disclosures*.

Measurement of expected credit losses for revolving credit facilities (Agenda Paper 3)

35. The submitter asked whether an exposure in excess of the contractually agreed credit limit could be used when estimating the exposure at default for revolving credit facilities in accordance with IFRS 9 when an entity has a history of allowing customers to exceed their contractually set credit limits.
36. ITG members noted that the impairment model in IFRS 9 is based on the contractual terms of a financial instrument. Specifically:
- (a) the definition of credit losses refers to a comparison between the contractual cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive; and
 - (b) the maximum period to consider when measuring expected credit losses is the maximum contractual period (including extension options) over which the entity is exposed to credit risk and not a longer period, even if that period is consistent with business practice.
37. ITG members noted that the exception for some types of revolving credit facilities set out in paragraph 5.5.20 of IFRS 9 relates to the contractual commitment period and does not address the contractual credit limit. ITG members noted that the Standard was clear in this regard and consequently, it would not be appropriate to analogise this specific exception to the contractual credit limit.
38. However, a number of ITG members pointed out that in practice, the tenor and amount of revolving credit facilities were inextricably linked, because banks not only extend credit for a period in excess of their maximum contractual commitment period but also allow customers to make drawdowns in excess of the maximum contractually agreed credit limit as notified to the customer. Consequently, they noted that if amounts in excess of the maximum contractually agreed credit limits are not taken into account, there would be a potential disconnect between the accounting and credit risk management view.
39. It was reaffirmed that the IFRS 9 impairment model was based on the contractual terms of the financial instrument at the reporting date and that the specific exception set out in paragraph 5.5.20 of IFRS 9 could not be extended by analogy. Consequently, IFRS 9 limits the estimation of future drawdowns to the contractually agreed credit limit. However, the staff acknowledged the views expressed by ITG members and agreed to inform the IASB about the difference between the accounting and credit risk management view in these circumstances.

Forward-looking information (Agenda Paper 4)

40. When applying the impairment requirements, IFRS 9 requires entities to consider all reasonable and supportable information that is available without undue cost and effort, including information that is forward-looking. The ITG considered two potential implementation issues related to forward-looking information:

- (a) whether forward-looking information, including macroeconomic information, should be incorporated into the determination of expected credit losses in a differentiated way—for example, country by country, bank by bank, portfolio by portfolio; and
 - (b) how to determine whether forward-looking information is reasonable and supportable for inclusion in the application of the impairment model. The question is particularly relevant within the context of information about emerging issues and uncertain future events, which is not usually included in an entity's current budgeting and forecasting processes.
- 41. With respect to the first issue, ITG members confirmed that, as noted in paragraphs B5.5.16 and B5.5.51 of IFRS 9, forward-looking information should be relevant for the particular financial instrument or group of financial instruments to which the impairment requirements are being applied. Different factors may be relevant to different financial instruments and accordingly the relevance of particular items of information may vary between financial instruments, depending on the specific drivers of credit risk. For example, this is highlighted in Example 5 to IFRS 9, in which 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 borrowers work in that industry in that specific region. Conversely, it was also noted that if different financial instruments or portfolios being assessed share some similar risk characteristics, then relevant forward-looking information should be applied in a comparable and consistent manner to reflect those similar characteristics.
- 42. With respect to the second issue, ITG members discussed the principles associated with determining whether forward-looking information is reasonable and supportable and therefore should be included in the application of the impairment requirements, as summarised below. The ITG did not comment on the appropriateness of the structured approach proposed by the submitter.
- 43. ITG members noted that the objective in the Standard is to determine expected credit losses by considering all reasonable and supportable information, including forward-looking information, that is relevant and available without undue cost or effort. Information with these characteristics is used in both the assessment of significant increases in credit risk and in the measurement of expected credit losses.
- 44. ITG members acknowledged that this was a challenging area. They observed that there will be a spectrum of forward-looking information available, some of which will be reasonable and supportable and some of which will have little or no supportable basis. Determining the information that is relevant and reasonable and supportable and its impact on the assessment of significant increases in credit risk and measurement of expected credit losses can require a high level of judgement. In addition, ITG members observed that it can be particularly challenging and difficult to determine the economic consequences (or 'second-order effects') of uncertain future outcomes. For example, while it may be possible to assess the likelihood of particular event occurring, it may be more difficult to determine the effect of the event on the risk of a default occurring and/or on the credit losses that would be associated with that event using reasonable and supportable information.
- 45. ITG members noted that the objective of the IFRS 9 requirements for measuring expected credit losses is to reflect probability-weighted outcomes. Accordingly, information should not be excluded from the assessment of expected credit losses simply because:
 - (a) the event has a low or remote likelihood of occurring; or
 - (b) the effect of that event on the credit risk or the amount of expected credit losses is uncertain.
- 46. ITG members emphasised that an entity should make an effort in good faith to estimate the impact of uncertain future events, including second-order effects, on the credit risk of financial instruments and the measurement of expected credit losses. The estimate should be based on all reasonable and supportable information that is relevant and available without undue cost and effort. Some ITG members made the following observations:

- (a) Estimates of expected credit losses should reflect an entity's *own* expectations of credit losses; however, entities should be able to explain how they have arrived at their estimate and how it is based on reasonable and supportable information.
 - (b) Estimates of expected credit losses are, by their nature, approximations, which will be updated as more reasonable and supportable information becomes available over time.
 - (c) Information does not necessarily need to flow through a statistical model or credit-rating process in order to determine whether it is reasonable and supportable and relevant for a particular financial instrument or group of financial instruments.
47. Some ITG members observed that if an entity could determine that an uncertain event has an impact on the risk of a default occurring, then it should be possible to make an estimate of the impact on expected credit losses, despite the potentially large range of outcomes. However, in some exceptional cases, it was acknowledged that it may not be possible to estimate the impact on expected credit losses, despite an entity's best efforts.
 48. In this regard, ITG members emphasised the importance of disclosure of forward-looking information that is relevant, but that cannot be incorporated into the determination of significant increases in credit risk and/or the measurement of expected credit losses because of the lack of reasonable and supportable information. Such disclosures should be consistent with the objective in IFRS 7, which is to enable users of the financial statements to understand the credit risk to which the entity is exposed.
 49. Several ITG members mentioned that the impact of scenarios about some uncertain future events for which there is reasonable and supportable information may need to be incorporated into the assessment of significant increases in credit risk and measurement of expected credit losses through the use of overlays to the 'base model', on a collective basis. However, in doing so, care needs to be taken to avoid double-counting the impact of events (in both the base model and the overlay) and to take into account the implications of significant correlations; for example, if the impact of a specific uncertain future event had already been captured through the macroeconomic forecasts included in the base model. ITG members highlighted that the estimate of expected credit losses must be consistent with the requirements in the Standard and in particular with the measurement objective for expected credit losses.
 50. ITG members emphasised the need for good governance and processes in this area, because of the uncertainties and continually changing circumstances associated with forward-looking information. Furthermore, an entity should be able to explain what information it had considered and why that information had been included or excluded from the determination of expected credit losses.

Update on BCBS guidance on expected credit losses

51. A representative from BCBS gave an update on the proposed BCBS guidance on accounting for expected credit losses.
52. The guidance would apply to internationally active banks and is expected to be published by the end of 2015.
53. The guidance will be in two parts: the first would contain general guidance regarding expected credit losses, and the Appendix would contain guidance about the application of IFRS 9. The BCBS will ask the IASB and the FASB to review the final guidance to ensure it does not contravene the relevant accounting standards.

Next steps

54. As noted in paragraph 39, IASB staff will inform the IASB, at one of its future meetings, about the potential difference between the accounting and credit risk management view when measuring expected credit losses for revolving credit facilities.
55. The next meeting of the ITG is to be held on 11 December 2015. Submissions received by Wednesday 21 October 2015 will be considered for inclusion in the agenda for that meeting.