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IFRS in Focus

First meeting of IFRS Transition Resource Group for Impairment of Financial Instruments

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This IFRS in Focus summarises the first meeting of the IFRS Transition Resource Group for Impairment of Financial Instruments ('ITG', 'the group') which took place on 22 April 2015.

Introduction

The ITG is a discussion forum established by the International Accounting Standards Board (IASB) to provide support for stakeholders on implementation issues arising from the new impairment requirements following the issue of IFRS 9 *Financial Instruments* (2014).

Overall, the purpose of the ITG is to:

- solicit, analyse and discuss stakeholder issues arising from implementation of the new impairment requirements;
- inform the IASB about those implementation issues, which will help the IASB determine what, if any, action will be needed to address those issues; and
- provide a public forum for stakeholders to learn about the new impairment requirements from others involved with implementation.

During the meetings, the ITG members share their views on the issues but the group will not issue any guidance. The IASB will determine what action, if any, will be taken on each issue. See the IASB's website for further information about the ITG and the **agenda papers** discussed.

This meeting of the ITG was introduced as the first of three planned meetings for the group in 2015. Further meetings had intentionally not been planned so as to provide a notional end date for submitting issues to the group to allow for a stable platform for implementation which is already underway in many cases. The staff provided a brief summary of issues that had been submitted to the group (which is available on the IASB's website) and noted that the eight issues discussed at this first meeting were the first eight that met the criteria for discussion by the ITG received before the cut-off date. Other issues subsequently received will be discussed at the next meeting (planned for 16 September 2015) if they meet the criteria for discussion by the ITG.

The meeting was attended by ITG members, the IASB staff ('the staff') and some IASB board members, one of whom chaired the meeting. The views expressed at the meeting did not represent authoritative views of the IASB.

For more information please see the following websites:

www.iasplus.com

www.deloitte.com

The topics are presented below in the order in which they were discussed by the group.

Topic 1 – Forecasts of future economic conditions

Background

IFRS 9 requires an entity to take into account forward looking forecasts of future economic conditions when determining significant increases in credit risk and when measuring expected credit losses. The assessment of whether there has been a significant increase in credit risk is performed *at each reporting date* and considers reasonable and supportable information that is available without undue cost or effort. Measurement of expected credit losses reflects reasonable and supportable information available without undue cost or effort *at the reporting date* about past events, current conditions and forecasts of future economic conditions.

Given the forward-looking nature of loan loss provisioning the ITG was asked whether and how to incorporate events and forecasts that occur after the date at which the measurement of expected credit losses is modelled which could have an effect both on the assessment of significant increase in credit risk and the measurement of expected credit losses. The events and new information may become known either:

(a) before the reporting period end (Issue 1); or

(b) between the reporting period end and the date of signing the financial statements (Issue 2).

For Issue 1, the ITG was asked to consider a scenario where a bank used inputs and assumptions developed a month before its reporting date to recognise and measure the loan loss allowance at the reporting date when before the year end an event occurs which would lead to a different measurement of the loan loss allowance (e.g. the removal of a currency peg by a central bank).

For issue 2, the ITG was asked to consider whether events that arose after the reporting date would be an adjusting or non-adjusting event depending on whether the event was considered a possibility at reporting date (e.g. new unemployment figures that reverse previous trends) or completely unexpected (e.g. a natural disaster).

IAS 10 *Events after the Reporting Period* distinguishes between events after the balance sheet date that:

(a) provide evidence of conditions that existed at the end of the reporting period (adjusting events after the reporting period); and

(b) are indicative of conditions that arose after the reporting period (non-adjusting events after the reporting period).

Furthermore, IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* acknowledges that as a result of uncertainties inherent in business activities, many items in financial statements cannot be measured with precision but can only be estimated. Loan loss allowances in respect of financial instruments is one of these items.

See ITG Agenda Paper 2 for additional details.

Summary

The staff introduced the topic and explained that, subject to materiality considerations, reasonable and supportable information of events and current conditions and forecasts of future economic conditions that becomes available *before* the reporting period end are required to be reflected in the assessment of significant increases in credit risk and the measurement of expected credit losses at the reporting date.

The staff also noted that events and new information *after* the reporting period end would need to be assessed to determine whether they are adjusting or non-adjusting events under IAS 10. For example, information about an event that happened before the reporting date might become available after the reporting date, which may need to be reflected in the measurement of expected credit losses at the reporting date such as bankruptcy of a customer, which usually confirms that the customer's balance was credit-impaired at the end of the reporting period. The staff explained that determining expected credit losses at the reporting period end is inherently dependent upon reasonable and supportable estimates and forecasts at the reporting date.

Many ITG members agreed with the staff that IFRS 9 requires assessment of credit risk and measurement of expected credit losses *at the reporting date* and should take into account information that becomes available before the reporting period end. From a practical standpoint ITG members noted that in preparation for the reporting date, loan losses may be measured in advance using information prior to the reporting date which would have to be updated to reflect conditions at the reporting date. However, in some cases adjustments would not be necessary on the grounds of materiality. A number ITG members spoke of the importance of having a robust process with appropriate governance, controls and transparency to demonstrate how the process is consistently applied and in compliance with the Standard.

Some ITG members noted that dealing with post reporting date adjustments will be particularly challenging and the necessity of these would depend on the specific facts and circumstances. For example the outcome of a public vote that takes place post the reporting date would not be adjusted for because the known outcome of the vote cannot not represent conditions at the reporting date. Instead, the assessment and measurement at the reporting date should take into account the probabilities of the various outcomes of the vote and their impact on the accounting for impairment. In this respect, some analogised to fair value and how its measure is based on expectations at the reporting date and would not take into account subsequent events such as a change in interest rates.

A number of ITG members reiterated that the nature of estimates is such that actual outcomes are often different, but the crucial point is that the estimates at the balance sheet date are based on reasonable and supportable forward-looking information available at the reporting date determined through a robust and well governed process. IAS 8.34 confirms that revisions of estimates due to changes in circumstances or as a result of new information does not relate to prior periods, hence any post reporting period end adjustments would have to be consistent with IAS 10 (which was not changed by the issue of IFRS 9).

In addition, the staff also explained that forward looking effects will be determined at the reporting date through assumptions based up on expert judgement and models that will produce estimates. Post reporting date events would have to be assessed in this context to determine if they are adjusting or non-adjusting in accordance with IAS 10.

Topic 2 – Loan commitments – scope

Background

An issuer of a loan commitment is required to apply the impairment requirements of IFRS 9 to loan commitments that are not otherwise in the scope of IFRS 9 (e.g. not at fair value through profit or loss). Loan commitment is not a defined term in IFRS, however, BCZ2.2 of IFRS 9 describes loan commitments as “firm commitments to provide credit under pre-specified terms and conditions”.

The lack of clear definition of a loan commitment has resulted in stakeholders asking whether commitments to extend credit that are not in the context of traditional ‘lending’ should be treated as loan commitments subject to the impairment requirements of IFRS 9. In particular the following two examples were raised to the ITG:

Example 1: A commitment (on inception of a finance lease) to commence a finance lease at a date in the future (i.e. a commitment to transfer the right to use an asset at the commencement date in return for a payment or series of payments in the future)

Example 2: A commitment by a retailer through the issue of a store account to give a customer credit when the customer buys goods or services from the retailer in the future with the following characteristics:

(a) the store accounts cannot be used to withdraw cash or to buy from other retailers or suppliers;

(b) at the time of issuing the store account, there is no specific sales agreement with the customer. The customer can use the account to purchase specific goods from the retailer, and the retailer agrees at that time (i.e. when the customer presents its card as form of payment) to sell those specific goods to the customer;

(c) the agreement between the retailer and the customer does not include an obligation of the issuer to supply goods or services to the customer;

(d) the retailer retains the credit risk and does its own credit checks before, and during, extending credit to the customer; and

(e) the retailer can revise or cancel the credit agreement at any time by providing the customer with the relevant notice.

See ITG Agenda Paper 3 for additional details.

Summary

In the agenda paper that was discussed, the staff posed two questions to determine whether the two examples above are in scope of the IFRS 9 impairment requirements:

Question 1: Is there a loan commitment (i.e. a firm commitment to provide credit under pre-specified terms)?

Question 2: Does the loan commitment meet the definition of a financial instrument (noting that the IFRS 9 impairment requirements only apply to loan commitments that are financial instruments)?

If the answer to both of these questions is yes, the commitment would be in scope of the IFRS 9 impairment requirements.

At the outset, the staff explained that the objective of the ITG discussion was not to answer the two questions for the examples presented but to discuss whether the two questions taken together would determine whether the commitment is in or out of scope.

A number of ITG members agreed that the two questions are determinative, however, one member noted that a third additional question is necessary if the answer to the first two questions is yes. That question would ask whether another scope exception would result in the commitment being outside scope of the impairment requirements. This was considered with the finance lease example in mind because even if the answer to questions 1 and 2 were yes, the scope exception in respect of leases could result in the commitment being outside scope of the IFRS 9 impairment requirements. The Chairperson agreed that this third question would be necessary.

The staff did not comment further on the answers to these questions for the examples presented but a number of ITG members expressed views that:

- the finance lease commitment would not meet the definition of a financial instrument and hence would not be in scope of the impairment requirements.
- the store card example would not give rise to a firm commitment because the issuer has discretion to refuse to sell products or services to the customer and even if it did the commitment would not represent a financial instrument.

One ITG member cited IAS 32.AG20 in support for the contracts not meeting the definition of a financial instrument which states: *"[c]ontracts to buy or sell non-financial items do not meet the definition of a financial instrument because the contractual right of one party to receive a non-financial asset or service and the corresponding obligation of the other party do not establish a present right or obligation of either party to receive, deliver or exchange a financial asset."*.

Topic 3 – Expected credit losses – measurement date

Background

IFRS 9 consistently refers to the requirement for an entity to measure expected credit losses at the reporting date. However, other sections of IFRS 9 (including the Illustrative Examples) and related requirements in other IFRSs imply that there is a requirement to measure expected credit losses at dates other than the reporting date, namely:

(a) at the date of derecognition; and

(b) at the date of initial recognition.

This raises the question of whether there is a conflict within IFRS or whether indeed loan loss allowances need to be measured at derecognition and initial recognition of financial assets at amortised cost or fair value through other comprehensive income (FVTOCI).

The agenda paper explained that measurement of expected credit losses at the date of derecognition of an asset at amortised cost is necessary because:

- IFRS 9.3.2.12 requires the difference between the carrying amount at the date of derecognition and the consideration received to be recognised in profit or loss; and
- IAS 1 (paragraphs 82(aa) and 82(ba)) requires that separate line items are presented for gains and losses arising from derecognition and impairment losses and reversals.

The carrying amount refers to amortised cost which includes the adjustment for any loan loss allowance. Therefore the loan loss allowance at derecognition is necessary to measure the gain or loss on derecognition. Furthermore, since the FVTOCI measurement category recognises information in profit or loss as if the financial assets were measured at amortised cost this is also required for FVTOCI assets derecognised. This requirement was not seen as a conflict within IFRS 9 but rather the specific derecognition requirements of IFRS 9. The staff note that in accordance with IAS 8.8, an entity would consider the materiality of the items in question when considering the above requirement.

With respect to measuring the loss allowance on initial recognition, the staff explain in the agenda paper that this is necessary for assets denominated in a foreign currency in order to appropriately capture foreign exchange gains and losses on the financial asset going forward (as required by IAS 21 *The Effects of Changes in Foreign Exchange Rates*). Illustrative Example 14 of IFRS 9 presents the accounting entries upon initial recognition of a foreign currency-denominated asset measured at FVTOCI and shows that the loss allowance is measured at initial recognition. This is to recognise the change from movements in foreign exchange rates on the amortised cost of the asset (i.e. including the loss allowance) denominated in the foreign currency. Again, the staff note that in accordance with IAS 8.8, an entity would consider the materiality of the items in question when considering the above requirement.

See ITG Agenda Paper 7 for additional details.

Summary

ITG members that expressed a view agreed with the staff that in order to calculate the gain or loss on derecognition of a financial asset at amortised cost or FVTOCI it will be necessary to determine the loss allowance at derecognition. From a practical standpoint, however, it was noted that a recent measure of the loss allowance may serve as an acceptable proxy subject to IAS 8 materiality considerations. The group went on to discuss the likelihood of having recent measures of loan loss allowances for derecognised assets and noted that this would depend on the frequency with which the loss allowances are calculated. For example, it would likely need to be assessed more frequently than annually and could perhaps be monthly. Some noted that for many institutions (e.g. smaller national banks) monthly would not be practical. In any case, it was noted that an assessment of whether the most recent measure is appropriate would have to be assessed based on the specific facts and circumstances.

With respect to the need to calculate the loan loss allowance on initial recognition a number of ITG members disagreed that it was necessary for the purpose of applying IAS 21. They noted that IFRS 9.5.1.1 requires financial assets to be initially recognised at fair value and therefore this balance can be used as the opening value for IAS 21 foreign currency translation purposes with the closing value at the reporting period end including the loss allowance as required by IFRS 9. It was therefore acknowledged that the method presented in the Illustrative Example 14 is not the only acceptable approach to applying IFRS 9 and IAS 21.

Topic 4 – Assessment of significant increase in credit risk for guaranteed debt instruments

Background

A guaranteed debt instrument is a financial asset that includes a financial guarantee contract that is integral to its contractual terms such that if the debtor failed to pay the holder would seek recovery from the guarantor under the terms of the debt instrument.

IFRS 9 requires an entity to assess whether there has been a significant increase in credit risk since initial recognition to determine whether a loss allowance for lifetime expected losses should be recognised. The ITG was asked for its views on whether an entity should consider the ability to recover cash flows through the integral financial guarantee contract when assessing whether there has been a significant increase in credit risk of the guaranteed debt instrument.

If the financial guarantee contract is taken into account, and, for example, there has been a significant increase in the risk of the debtor defaulting, if the credit quality of the guarantor were considered, the entity may still assess that there has not been a significant increase in the credit risk of the financial instrument. This may be because the terms of the guarantee provide for prompt recovery from the guarantor in the case of non-payment by the debtor and there is no significant increase in the risk of the guarantor failing to pay under the guarantee.

The staff's analysis in the agenda paper highlighted the following:

IFRS 9.5.5.9 requires that credit risk be assessed by considering the change in the risk of a default occurring since initial recognition and IFRS 9.B5.5.12/22 show that collateral is not taken into account when assessing credit risk (rather it is taken into account when assessing recoverable cash flows in the case of default). Therefore excluding recoveries from integral financial guarantee contracts when assessing significant increases in credit risk would be consistent with the treatment of collateral.

IFRS 9.B5.5.17 refers to 'increased amounts of collateral or guarantees' and 'significant changes in the value of collateral supporting the obligation or in the quality of third-party guarantees or credit enhancements' as information that may be relevant in assessing changes in credit risk. However, these requirements are included to the extent that these factors influence the risk of the borrower defaulting and do not indicate that the risk of default can be considered to be reduced by the ability to recover under the collateral or guarantee arrangements.

See ITG Agenda Paper 5 for additional details.

Summary

Many ITG members agreed that the standard is clear that the probability of default does not include recoveries from integral financial guarantee contracts. However, it was noted that the expected behaviours of the guarantor may influence the probability of default. To illustrate this point the example in IFRS 9.B.5.5.17(k) was mentioned which considers a shareholder (or individual's parents) who might have an incentive and financial ability to prevent default by providing the debtor with capital or cash. The likelihood of the guarantor funding the debtor directly versus paying the lender for a claim under guarantee will have an impact on the probability of default.

A number of ITG members did not like the outcome of applying the requirements of the standard (i.e. excluding recoveries in the assessment of credit risk) as they felt that this was inconsistent with risk management practice which would consider the credit risk including recoveries under the guarantee. Furthermore these members felt that it would have little impact on measurement (i.e. loss allowance would remain low) but would give rise to additional disclosures which would not be consistent with the risk management approach. One member questioned whether the difference in approach (i.e. include versus exclude recoveries in assessment of credit risk) would be material.

It was noted that regulators are interested not only in the loss allowances but also in credit risk migration and so an understanding of which stage an asset is in based on the credit risk excluding recoveries from the guarantee has important information value, especially since the recoveries from the guarantor can change (e.g. based on their circumstances) in the same way that collateral values can change (e.g based on market prices).

Topic 5 – The maximum period to consider when measuring expected credit losses

Background

When measuring expected credit losses, IFRS 9 states that the maximum period to consider when measuring expected credit losses is the maximum contractual period (including borrower extension options) over which the entity is exposed to credit risk and not a longer period, even if that longer period is consistent with business practice. IFRS 9 includes a narrow exception to this rule for financial instruments that include both a loan and an undrawn commitment component and the lender's contractual right to demand repayment and cancel the undrawn commitment does not limit the entity's credit losses to the notice period (e.g. revolving credit facilities such as credit cards and overdrafts). Given these requirements, the ITG was asked to consider the following example and question:

Bank A manages a portfolio of variable rate mortgages on a collective basis. The mortgage loans are issued to retail customers in Country X with the following terms:

- the stated maturity is six months with an automatic extension feature whereby, unless the borrower or lender take action to terminate the loan at the stated maturity date, the loan automatically extends for the following six months;
- the interest rate is fixed for each six month period at the beginning of the period. The interest rate is reset to the current market interest rate on the extension date; and
- the lenders right to refuse an extension is unrestricted.

It is assumed that the mortgage loans meet the criteria for amortised cost measurement under IFRS 9.4.1.2.

In practice, borrowers are generally expected not to elect to terminate their loans on the stated maturity date, because moving the mortgage to another bank, or applying for a new product, generally involves an administrative burden and has little or no economic benefit for the borrower.

Furthermore, Bank A does not complete regular credit file reviews for individual loans and as a result does not usually cancel the loans unless it receives information about an adverse credit event in respect of a particular borrower. On the basis of historical evidence, such loans extend many times – and can last for up to 30 years.

Question: What is the maximum period Bank A should consider when measuring expected credit losses under IFRS 9, if the contractual extension option is subject to lender's non-objection?

See ITG Agenda Paper 1 for additional details.

Summary

Many ITG members agreed with the staff's analysis in the agenda paper that the standard is clear that in this scenario the maximum period to consider when measuring expected credit losses is six months because the lender is not contractually compelled to lend beyond six months. These members noted that the narrow exception in IFRS 9.5.5.20 that allows an entity to look beyond the maximum contractual period for financial instruments that include both a loan and an undrawn commitment component did not apply to this scenario. However, some others questioned why the exception would not apply since despite the reference to including "both a loan and an undrawn commitment component" this exception was expected to apply in cases where the full loan has been drawn down with no remaining undrawn component which could be seen as similar to the fact pattern presented. This led to a discussion about the scope of IFRS 9.5.5.20 and it was noted by the Chairperson that they viewed this paragraph as applying in cases where the financial instrument could have a drawn and undrawn component and did not depend on how much was drawn at any point in time (i.e. doesn't matter if fully drawn or undrawn). Therefore, given that the example being considered cannot have an undrawn element (i.e the loan is for a pre-determined set amount that is advanced to the borrower) IFRS 9.5.5.20 does not apply.

It was noted that in the example presented, because the lender could choose not to extend the loan beyond six months this limits its credit risk on the loan to six months even if the lender does not actively exercise this right to actually limit its credit risk.

Some members noted that the accounting outcome of only looking to six months is inconsistent with the risk management view which would typically look beyond the six month period given the expected behavioural life is longer than six months. Others also mentioned the risk of unintended consequences with entities structuring their instruments to limit the time horizon over which expected losses are calculated.

In assessing the maximum contractual term it was noted that only substantive terms of the contract should be considered such that if in the environment that the loan was issued the lender would be required to extend the loan (e.g the lender extension option is not substantive because the lender does not have a choice and is required to extend due to law or regulation) it would have to look beyond the six month term.

Topic 6 – Revolving credit facilities

Background

For revolving credit card facilities, the ITG was asked to consider two separate issues:

- Over what term expected credit losses should be calculated (Issue 1)
- What should the date of initial recognition be for the purpose of assessing significant increase in credit risk? (Issue 2)

The following example and questions were used as a basis for discussion.

Issue 1

- Bank A holds a portfolio of revolving credit facilities (e.g. credit cards).
- The average life of a card that does not default is five years. Because Bank A has had a steady book for a number of years the average remaining life is two and a half years at the reporting date.
- On average cards that default do so 18 months after the card was originated and nine months after a significant increase in credit risk. Because Bank A has had a steady book for a number of years, the average remaining lives at the reporting date would be nine months and four and a half months respectively.
- Every card has the same credit limit of CU1,000 and the average month end balance is CU500.
- The credit risk management policy of Bank A is to monitor the monthly balance in relation to previous activity and the credit limit set on the card. Bank A also receives some information from an external credit bureau on the credit standing of individual customers – e.g. if a customer fails to make a payment on a card or other loan with another lender in the same jurisdiction or the customer's overall credit score increases for other reasons.
- Bank A judges that a significant increase in credit risk occurs for an individual customer when any of the following occur (in addition Bank A makes a collective forward-looking overlay that considers macroeconomic factors, e.g. unemployment rates):
  - the customer made only the minimum monthly repayment for either two consecutive months or for more than three months in the last 12;
  - the customer has failed to make a payment on a loan with a different lender or external data indicates its credit risk has increased for other reasons; and
  - the customer has failed to make one (or more) minimum monthly repayments.

If any of the above occurs, Bank A:

- lowers any unused credit limit (though is unlikely to withdraw it completely, because doing so would not meet local regulatory requirements to 'treat customers fairly') – to an average of CU700;
- contacts the customer to discuss his/her finances; and
- withdraws any bonus rates (e.g. on balance transfers etc.) that the customer had been entitled to, so the interest rate reverts to the standard APR – with the aim of discouraging the customer from using the card further, because it has become more expensive to do so.

A card is deemed to be in default when the borrower has failed to make the minimum monthly repayment required for two consecutive months. At this point, Bank A contacts the customer again to initiate recovery proceedings.

At the reporting date, 75 per cent of cards have not suffered a significant increase in credit risk and so are in Stage 1; 20 per cent of cards have suffered a significant increase in credit risk and so are in Stage 2; and the other 5 per cent have defaulted (i.e. are credit impaired and are in Stage 3). Of those in Stage 2, half (i.e. 10 per cent of the total number of cards) are expected to default and the other half are expected to 'cure' and not default.

It is assumed that the portfolio meets the conditions of IFRS 9.5.5.20, which allows the calculation of expected credit losses to go beyond the 'on-demand' notice period.

Questions: What life should be used under IFRS 9 to calculate expected credit losses for:

(a) assets in Stage 1;

(b) assets in Stage 2; and

(c) assets in Stage 3?

Issue 2
Bank A holds a portfolio of revolving credit facilities (e.g. credit cards).

The portfolio includes some customers that have had a credit card with the bank for many years (20 years +), while others only opened a credit card account within the last month. The weighted average time that customers have had a credit card with the bank is five years.

For customers that have had a credit card with the bank for many years, several events may have taken place:

- the customer may have changed to a different type of card. For example, a customer may have initially taken out a card while a student and at that time had a 'student card'; then later may have changed to a 'standard card'; and sometime later still may have changed again to a 'premium card' (e.g. once their income met a specified minimum level and/or paying an annual fee in return for enhanced benefits).

- the bank may have increased the customer's credit limit, in some cases multiple times. This may have been in response to a request from the customer (subject to the customer meeting the bank's credit criteria), or initiated by the bank.

- the bank conducts an annual review of each credit card facility once a year. This is a largely automated process that in many cases results in no change to the terms of the card account. But in some cases it may result in the customer's credit limit being increased or decreased or to other changes to terms and conditions.

It is assumed that the portfolio meets the conditions of IFRS 9.5.5.20.

Question: How should Bank A determine the date of initial recognition of the revolving credit facilities (for the purpose of determining if there has been a significant increase in credit risk since initial recognition)?

See ITG Agenda Paper 4 for additional details.

Summary

Issue 1
Of the three stages for the portfolio of assets discussed, some members noted that the time horizon for assets in stage three was the most straight forward and agreed with the analysis in the agenda paper that because Bank A would have already taken actions to terminate the credit facility it should take into account the cash flows it expects to recover from the portfolio and calculate expected credit losses based on these.

For the assets in stage one and stage two it was noted by some that the fact pattern in the example was simplified and in practice more detailed information would be required. A key point that was emphasised during the discussion was that for financial instruments that include both a loan and an undrawn commitment, although IFRS 9.5.5.20 does not limit the time horizon of the entity's exposure to credit losses to the contractual notice period, this does not mean that the behavioural life of the instrument should be used. Instead the entity measures 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. Therefore the ability to take mitigating credit risk management actions could limit the time horizon to a period shorter than the average behavioural life. For example, if a bank holds a portfolio of instruments where the expected life is 30 years, expected losses would not be calculated over the 30 year period because in practice credit risk mitigants would be in place which limit this to a shorter period.

During the discussion it was also emphasised that the objective of IFRS 9 for stage 1 is to look at the probability of default over the next 12 months and then consider the cash shortfalls from this over the full life of the instrument.

A number of ITG members noted that the time horizon over which expected credit losses should be considered would be captured by segmenting and stratifying the portfolio based on its characteristics and vintage. Some members were not clear on the distinction between behavioural life and the time to when credit risk mitigation would take place with some believing they would be the same – i.e. the life of the instrument would be cut short by credit risk mitigation which then drives the behavioural life. However, others noted that on a portfolio basis different outcomes could arise and this should be considered as part of the probability assessments and segmentation (e.g. assets in stage 2 would be managed differently and hence the behavioural life is shorter).

It was evident from discussions that the implementation of these requirements is a challenging area which continues to be work in progress.

Issue 2

The staff introduced the topic by explaining that IFRS provides requirements regarding the date of initial recognition for financial assets and loan commitments, i.e.:

(a) in respect of financial assets, IFRS 9.3.1.1 states:

An entity shall recognise a financial asset or a financial liability in its statement of financial position when, and only when, the entity becomes party to the contractual provisions of the instrument (see paragraphs B3.1.1 and B3.1.2 of IFRS 9).

(b) in respect of loan commitments, IFRS 9.5.5.6 states:

For loan commitments and financial guarantee contracts, the date that the entity becomes a party to the irrevocable commitment shall be considered to be the date of initial recognition for the purposes of applying the impairment requirements.

The Chairperson noted at the outset of the discussion that the issue presented was more a question of initial recognition and derecognition, and these requirements have not changed from the requirements in IAS 39, rather than a question of expected credit losses, but nevertheless thought it was relevant for discussion by the ITG.

During discussion a number of ITG members noted that this is a particularly challenging aspect of implementing the new impairment model. This is because of the evolving nature of the instruments with continual changes in terms of products and changes in the customer’s profile and characteristics over time.

It was noted by the group that the treatment would come down to an assessment of whether the instrument is a new instrument which may be clear in some cases (e.g. a customer is granted a new product) but more judgemental in other cases (e.g. where the terms of an existing product has been modified). Therefore judgement would need to be exercised to implement these requirements.

Topic 7 – Measurement of expected credit losses for an issued financial guarantee contra

Background

Financial guarantee contracts within the scope of IFRS 9 and not at fair value through profit or loss are subject to the IFRS 9 impairment requirements. IFRS 9 requires that following the fair value measurement at initial recognition, the issuer subsequently measures the financial guarantee contract at the higher of:

(a) the amount of the provision for expected credit losses; and

(b) the amount initially recognised less, when appropriate, the cumulative amount of income recognised in accordance with the principles of IFRS 15 *Revenue from Contracts with Customers*.

Therefore it is necessary to calculate the provision for expected losses for such financial guarantees issued. The measurement of expected credit losses is a probability weighted estimate (i.e. the present value of all cash shortfalls) over the expected life of the guarantee.

IFRS 9.B5.5.32 requires that:

For a financial guarantee contract, the entity is required to make payments only in the event of a default by the debtor in accordance with the terms of the instrument that is guaranteed. Accordingly, cash shortfalls are the expected payments to reimburse the holder for a credit loss that it incurs less any amounts that the entity expects to receive from the holder, the debtor or any other party. If the asset is fully guaranteed, the estimation of cash shortfalls for a financial guarantee contract would be consistent with the estimations of cash shortfalls for the asset subject to the guarantee.

The issue submitted for discussion by the ITG relates to financial guarantee contracts that are issued by an entity where the entity receives regular premiums from the holder over the life of the guarantee(as opposed to receiving all the premium upfront) and whether the measurement of expected credit losses should be reduced by future premium receipts that may be deducted from the amount the guarantor would pay in the case of default.

See ITG Agenda Paper 6 for additional details.

Summary

The staff introduced the issue by explaining their view that the future premium receipts should be ignored and only recoveries or reimbursements of claims for losses should be included as a reduction in the cash shortfalls calculated under IFRS 9.B5.5.32. This approach would give a consistent measurement of expected credit losses for financial guarantee contracts irrespective of whether or not premiums are receivable over the life of the contract or as a single premium at the inception of the contract.

The ITG members briefly discussed this issue with those contributing to the discussion agreeing with the staff's analysis. One member noted however that financial guarantee contracts come with different terms and this should be considered when calculating the appropriate provision which may result in the period of exposure to credit risk being shorter. For example some guarantees may have annual variable premiums which would have to be paid for the contract to continue which allows either party to terminate the contract annually (i.e. pay as you go contracts).

Topic 8 – Measurement of expected credit losses in respect of a modified financial asset

Background

IFRS 9 includes requirements on how to account for modified financial assets when the modification does not result in derecognition. It stipulates that in such circumstances, an entity shall recalculate the gross carrying amount of the financial asset and recognise a modification gain or loss in profit or loss.

Under IFRS 9, following modification that does not lead to derecognition the impairment model continues to apply in the same way as it does for other unmodified financial instruments but based on the new contractual terms.

IFRS 7 requires disclosures about the nature and effect of modifications of contractual cash flows on financial assets that have not resulted in derecognition and the effect of such modifications on the measurement of expected credit losses. The objective of this is to enable users of financial statements to understand the effect of credit risk on the amount, timing and uncertainty of future cash flows.

At the meeting the ITG members were asked to consider the following example and questions for discussion:

- Bank A originates a loan which meets the conditions of IFRS 9.4.1.2 and is therefore measured at amortised cost.
- Subsequently Bank A determines that the loan has suffered a significant increase in credit risk and consequently recognises lifetime expected credit losses.
- Immediately after, Bank A renegotiates the terms of the loan with the borrower in order to take into consideration the amounts that Bank A expects the borrower can repay—i.e. the contractual cash flows of the original loan are reduced.
- It is assumed that the loan is not credit-impaired at initial recognition and is not in a fair value hedge relationship; the modification does not result in derecognition; and there has been no observable reduction in credit risk and so the entity is required to continue to calculate lifetime expected credit losses.

Question 1: How should Bank A calculate the modification gain or loss?

Question 2: How should Bank A measure the new lifetime expected credit loss allowance at the reporting date?

Question 3: How should the modification gain or loss and movement on the expected credit loss allowance be presented?

Question 4: What modifications are included in the disclosures required by IFRS 7.35J?

See ITG Agenda Paper 8 for additional details.

Summary

A number of ITG members agreed with the staff's analysis as presented in the agenda paper and summarised below.

Question 1:

The modification assessment and modification gain or loss is based on the gross carrying amount of the asset and does not consider the loan loss allowance which is dealt with separately. However, on a related point it was noted by some ITG members that write-offs, which arise when the lender has no reasonable prospect of recovering further cash flows from the financial asset would affect the gross carrying amount and therefore could impact the modification accounting.

Question 2:

Following modification the loan loss allowance would be recalculated based on the new modified terms of the instrument but given continued recognition of the instrument the assessment of credit risk would be performed relative to initial credit risk on initial recognition. In the example presented the expected credit losses are based on lifetime expected losses and this would include a probability weighted measurement considering the possibility of a default occurring. Therefore the loss allowance would not simply be nil because the cash flows have been modified to amounts that the Bank expects the borrower can repay.

Question 3:

IFRS 9 does not prescribe which line item in the statement of profit or loss and other comprehensive income modification gains and losses should be presented.

However, Bank A should consider the requirements in IAS 1.85 regarding when it is appropriate to present additional line items in the statement of profit or loss and other comprehensive income. Consequently, if separate presentation of the modification gain or loss would be considered relevant to an understanding of the entity's performance, Bank A should present them separately.

As regards the movement on the expected credit loss allowance, Bank A should consider the requirements in IAS 1.82(ba), which requires a separate line item in the statement of profit or loss in respect of impairment losses and reversals.

One ITG member questioned the information value of presenting losses on modification in a separate line from impairment gains when both arise from the modification of an asset but the Chairperson noted that the modification loss shown separately provides information on the loss arising from a change to the contractual terms of the instrument.

Question 4:

The disclosures required by IFRS 7.35J apply to all modifications of contractual cash flows.

Consequently, Bank A must consider the overall objective of credit risk disclosures as explained in IFRS 7.35B and should comply with the disclosure requirement relating to modifications insofar as the items in question are considered to be important to achieving that objective.

Key contacts

ITG Member	*Lead IFRS Financial Instruments Partner*
Hervé Phaure	Andrew Spooner
hphaure@deloitte.fr	aspooner@deloitte.co.uk

IFRS centres of excellence		
Americas		
Canada	Karen Higgins	ifrs@deloitte.ca
LATCO	Claudio Giaimo	ifrs-LATCO@deloitte.com
United States	Robert Uhl	iasplus-us@deloitte.com
Asia-Pacific		
Australia	Anna Crawford	ifrs@deloitte.com.au
China	Stephen Taylor	ifrs@deloitte.com.cn
Japan	Shinya Iwasaki	ifrs@tohmatsu.co.jp
Singapore	Shariq Barmaky	ifrs-sg@deloitte.com
Europe-Africa		
Belgium	Thomas Carlier	ifrs-belgium@deloitte.com
Denmark	Jan Peter Larsen	ifrs@deloitte.dk
France	Laurence Rivat	ifrs@deloitte.fr
Germany	Jens Berger	ifrs@deloitte.de
Italy	Massimiliano Semprini	ifrs-it@deloitte.it
Luxembourg	Eddy Termaten	ifrs@deloitte.lu
Netherlands	Ralph Ter Hoeven	ifrs@deloitte.nl
Russia	Michael Raikhman	ifrs@deloitte.ru
South Africa	Nita Ranchod	ifrs@deloitte.co.za
Spain	Cleber Custodio	ifrs@deloitte.es
United Kingdom	Elizabeth Chrispin	deloitteifrs@deloitte.co.uk

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