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Expected credit losses

A step change in accounting for impairment

March 2013, Issue 2013/04

IN THE HEADLINES

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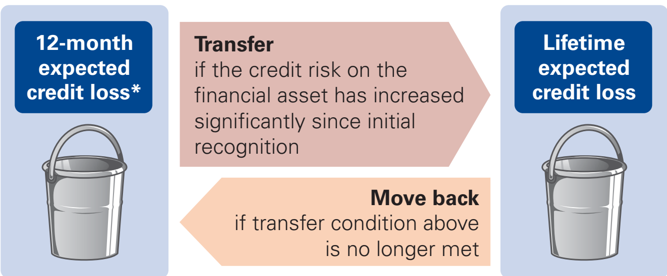
> "The proposals are a step change in accounting for impairment and are likely to have a significant impact on banks and similar financial institutions."
>
> – Andrew Vials,
> KPMG's global IFRS financial instruments leader

Impairment allowance required for expected losses

The IASB proposes replacing the current 'incurred loss' model with an 'expected loss' approach, which means that a loss event would no longer need to occur before an impairment allowance is recognised. The proposals aim to address concerns about 'too little, too late' provisioning for loan losses and would accelerate recognition of losses.

In general, the proposed expected loss model uses a dual measurement approach, as follows.



* 12-month expected credit losses are defined as the expected credit losses that result from those default events on the financial instrument that are possible within the 12 months after the end of the reporting period.

At the end of each reporting period, financial assets would be transferred from the '12-month expected credit loss' category to the 'lifetime expected credit loss' category – and therefore increase the amount of impairment – if their credit risk has increased significantly since initial recognition. However, the proposals do not define what is meant by 'significant' – so judgement would be needed to determine whether an asset should be transferred between categories.

The new model would apply to financial assets that are:

- recognised on-balance sheet, such as loans or bonds; and
- measured either at amortised cost or mandatorily at fair value, with gains and losses recognised in other comprehensive income.

It would also apply to certain loan commitments and financial guarantees.

A simplified approach would be available for certain trade and lease receivables. Special rules would apply for assets that are credit-impaired on initial recognition.

FASB has issued different proposals

The IASB and the FASB had been jointly developing a so-called 'three-bucket' impairment model. However, following constituent feedback, in December 2012 the FASB issued its own proposals for a single measurement approach using only lifetime expected credit losses. The FASB's comment date of 30 April 2013 leaves little time for constituents to fully consider the differences between the two models in their responses to the FASB, but the Boards have indicated that they plan to discuss jointly the comments received on their respective proposals.

Judgements – new complexities and wider scope

Estimating impairment is an art rather than a science, involving difficult judgements about whether contractual cash flows on an asset will be paid as due – and, if not, how much will be recovered and when. The proposed model widens the scope of these judgements.

The model relies on entities being able to make robust estimates of:

- expected credit losses; and
- the point at which there is a significant increase in credit risk since initial recognition of an asset.

These estimates would need to include the best information that is available without undue cost and effort, about:

- future changes in economic and market conditions; and
- how such changes would impact expected cash flows.

The proposals do not prescribe a specific method for calculating expected losses, so the method is likely to vary based on the type of financial asset, the information available and the entity's existing credit systems. Entities would need to develop appropriate methodologies and controls to ensure that judgement is exercised properly and consistently throughout the organisation, and supported by appropriate evidence.

Operationalising the proposals may be challenging

The proposed methodology would be likely to have a significant impact on the systems and processes of banks, insurers and other financing companies, due to the extensive new requirements for data and calculations. Other entities would also be affected, because the proposals impact the accounting for trade receivables. However, the impact for these entities is likely to be much smaller, because certain simplifications are available.

Extended data/calculation requirements may include:

- estimates of 12-month expected losses;
- estimates of lifetime expected losses; and

- information and data to show whether significant deterioration in credit risk has occurred or reversed.

Entities that plan to use data already captured for capital requirements under the Basel II framework would need to identify any differences between the two sets of requirements.

Equity and covenants may be affected

Initial application may result in a large negative impact on equity for banks and, potentially, insurance and other financing companies; it may also affect covenants. This is because equity would no longer incorporate merely incurred credit losses but also expected credit losses.

The impact on an entity would be substantially affected by:

- the size and nature of its financial instruments;
- the judgements that it has made in applying the existing requirements; and
- the judgements that it has made in applying the proposed model.

Applicable tax requirements may also influence the impact on an entity.

Entities should assess the impact and develop a plan to mitigate any negative consequences. They may need to discuss with analysts, shareholders, regulators and providers of finance before applying the new model.

Impact on KPIs likely, especially for banks, insurers and similar entities

Because credit risk is at the heart of a bank's business, and an important element of an insurer's business, transition to the expected loss model is likely to have a significant impact on their key performance indicators (KPIs). In addition, the proposed model may introduce new volatility in financial statements, because:

- loss estimates would apply to all financial assets – rather than only those assets for which losses have been incurred;
- market data used as an input factor(s) may be volatile – e.g. ratings, credit spreads and predictions about future conditions; and
- any move from a 12-month expected credit loss measurement to a lifetime expected credit loss measurement may result in a big change in the corresponding allowance.

As well as understanding these impacts, banks would have to factor the new requirements into their stress testing, to ensure that any potential impact under negative assumptions is properly understood.

Extensive disclosure requirements

Sourcing the additional information required for the proposed disclosures could be a complex and time-consuming exercise affecting resources, systems and processes.

The impacts may be felt right across your organisation

Preparing for the far-reaching impacts of these changes may take considerable effort. Start assessing the possible impact on your business now.

> “Credit risk is at the heart of a bank's business and the proposed model is expected to have far-reaching implications for their credit systems and processes. Banks may face significant implementation issues.”
>
> – Chris Spall,
> KPMG's global IFRS financial instruments deputy leader

Basic facts

ED/ 2013/3 *Financial Instruments: Expected Credit Losses* was issued by the IASB on 7 March 2013 as part of the IASB's project to replace the financial instruments standard (IAS 39 *Financial Instruments: Recognition and Measurement*).

The proposals would replace the impairment requirements under IAS 39 and would be included in IFRS 9 *Financial Instruments*.

This ED supersedes ED/2009/12 *Financial Instruments: Amortised Cost and Impairment*, published by the IASB in November 2009, and the *Supplement to ED/2009/12 Financial Instruments: Amortised Cost and Impairment*, published in January 2011.

The proposals would be applied retrospectively with some exemptions. Restatement of prior periods would not be required but permitted only if information is available without the use of hindsight.

The comment period ends on 5 July 2013; however, the effective date for the proposed standard has not been specified.

Timeline

7 March 2013:
Exposure draft published

5 July 2013:
Comment period ends

Not established:
Earliest date of adoption

Not established:
Earliest year end for which proposals would apply

Publication name: *In the Headlines – Expected credit losses*

Publication number: Issue 2013/04

Publication date: March 2013

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