Issue 4, February 2017

IFRS 9 Impairment

IFRS Newsletter

The IASB discussed how the period of exposure is determined for revolving credit facilities such as credit cards.

What happened in February 2017?

At its February 2017 meeting, the IASB discussed an area that has presented challenges for entities applying the impairment requirements of IFRS 9 *Financial Instruments*. The issue is how to incorporate credit risk management actions into determining the period of exposure when measuring expected credit losses (ECLs) for instruments in the scope of paragraph 5.5.20 of IFRS 9 – i.e. revolving credit facilities such as credit cards.

The IASB staff provided a summary of the relevant requirements of IFRS 9 and the related observations made by members of the IFRS Transition Resource Group for Impairment of Financial Instruments (ITG) in their meetings. The main observations were about how to apply paragraph B5.5.40 of IFRS 9 and included a reiteration of the following.

- In determining the period of credit exposure, an entity is required to consider all three factors listed in paragraph B5.5.40 – i.e. the entity considers if and how its credit risk management actions affect the period of exposure.
- If an entity chooses not to take credit risk-mitigating actions on some instruments, then this decision affects the expected life of the related financial instrument.
- An entity is required to consider the effects of its credit risk management actions to the extent that they mitigate credit risk.

The staff also provided a simplified illustration of how the principles in paragraph B5.5.40 might be applied.

The Board had no questions or comments on the summary given by the staff.

Next steps

The staff informed the Board of their intention to develop educational material on this and other challenging areas – should the need arise – to support IFRS 9 implementation.

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Period of exposure for revolving credit facilities

When measuring ECLs under IFRS 9, how is the period of exposure for revolving credit facilities such as credit cards determined?

An entity is required to consider all three factors listed in paragraph B5.5.40 of IFRS 9.

What's the issue?

When measuring ECLs, IFRS 9 generally requires that the maximum period to consider is the maximum contractual period over which the entity is exposed to credit risk. A longer period of exposure cannot be used, even if this is consistent with business practice.

However, paragraph 5.5.20 of IFRS 9 sets out a limited exception to this requirement. It applies to financial instruments that include both a loan and an undrawn commitment component, where the entity's contractual ability to demand repayment and cancel the undrawn commitment does not limit its exposure to the contractual notice period. A typical credit card is one such instrument. Interpretation of this paragraph has proved difficult in practice and has been the subject of multiple discussions by the ITG. One of the areas of difficulty is how to estimate the period of exposure for financial instruments in its scope.

Paragraph B5.5.40 of IFRS 9 provides guidance on applying paragraph 5.5.20 and requires entities to consider the following three factors when determining the period of exposure.

a. The period over which the entity was exposed to credit risk on similar financial instruments.

b. The length of time taken for related defaults to occur on similar financial instruments following a significant increase in credit risk.

c. The credit risk management actions that an entity expects to take once the credit risk on the financial instrument has increased – e.g. the reduction or removal of undrawn limits.

Questions have arisen about how these requirements, especially (c), should be applied in practice.

What the ITG previously discussed

Previous ITG discussions considered questions about this topic (see Issue 1 and Issue 3 of our *IFRS Newsletter: IFRS 9 Impairment*). At its December 2015 meeting, the ITG discussed how paragraph B5.5.40 should be applied. It noted[1] that to determine the end-point of the exposure, an entity should consider only credit risk management actions that it expects to take and only those that serve to mitigate credit risk.

The main observations were about how to apply paragraph B5.5.40.

What the IASB discussed in February 2017

The staff pointed out that the first step in the analysis is for an entity to determine whether a financial instrument is in the scope of paragraph 5.5.20.

1. Paragraph 40 in the official minutes.

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The staff then made the following observations about how to apply paragraph B5.5.40.

- In determining the periods of exposure for financial instruments in the scope of paragraph 5.5.20, an entity is required to consider all three factors listed in paragraph B5.5.40. This means that the entity considers if and how its credit risk management actions would result in a shorter period of exposure than if the entity considered only the first two factors.
- An entity's credit risk management policy – including the thresholds for taking credit risk management actions and the nature of those actions – is a relevant factor.
- If an entity chooses not to take credit risk-mitigating actions when it becomes aware of increases in credit risk, then this decision affects the period of exposure of the related financial instrument.
- A substantive credit review may be the end-point of the exposure period if the entity's normal business practice is to take credit risk-mitigating actions as part of this process and it expects to take such actions.
- If the entity expects to take credit risk-mitigating actions only on some but not all instruments that increase in credit risk, then this needs to be considered in the analysis.
- The entity is required to consider the effect of credit risk management actions to the extent that they mitigate credit risk – i.e. to the extent that they are expected to limit the expected life. An entity's ability to segment and stratify a portfolio into different sections of exposures that reflect the way those exposures are being managed is relevant in this regard.
- There is only one period to consider when determining the maximum period of exposure of a facility that applies equally to both drawn and undrawn components. However, credit risk-mitigating actions may affect the drawn and undrawn components differently. For example, cancelling the undrawn component removes the possibility of any future drawdowns but if repayment of the drawn component is demanded, then the recovery period for that drawn exposure still needs to be considered in measuring ECLs.

The IASB staff provided a simplified illustration.

The staff provided the following simplified illustration of how the principles in paragraph B5.5.40 might be applied. The illustration considers a portfolio of 100 facilities that are subject to substantive annual credit reviews that may be followed by credit risk-mitigating actions – i.e. removal of the undrawn component. An entity estimates that the following scenario will occur by the next review date.

Portfolio segment	Number of facilities	Increase in credit risk?	Credit risk-mitigating action taken?
A	30	Yes	Yes, for 15 of the 30 facilities No for the remaining 15
B	70	No	No

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The staff explained that in this scenario:

- the entity determines the period of exposure for the 30 facilities for which an increase in credit risk is expected (Segment A) separately from the other 70 facilities (Segment B);
- the period of exposure for 15 of the facilities in Segment A – for which the entity expects to remove the undrawn component – is shortened to the extent that the undrawn component exists, based on paragraph B5.5.40(c); and
- for the other 15 facilities in Segment A and for Segment B, the expected life is determined based on historical information and experience for similar financial instruments in accordance with paragraph B5.5.40(a) and (b).

KPMG insight

In practice, the analysis may need to be more complex than the staff's simplified illustration above. Possible complications include the following.

- For the exposures in Segment A for which the expected life is shortened based on paragraph B5.5.40(c), the entity needs to consider the recovery period for the drawn balance at the time when the undrawn component is cancelled.
- The other exposures in Segment A and those in Segment B may be subject to subsequent credit reviews that might prompt further credit risk management actions.
  - The other exposures in Segment A might be subject to more frequent or intensive reviews after the next annual review, based on the increase in credit risk determined at that review.
  - If the consideration of paragraph B5.5.40(a) and (b) indicates an expected life that extends more than 12 months beyond the next annual credit review, then it may be necessary to consider the results of the following review as well.

The staff intends to develop educational material.

Next steps

The staff informed the Board of their intention to develop educational material on this and other challenging areas – should the need arise – to support IFRS 9 implementation. The Board had no questions or comments on this, or the summary given by the staff.

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The story so far

The new expected credit loss model for the impairment of financial instruments to be introduced by IFRS 9 *Financial Instruments* will have a significant impact on the way banks account for credit losses on their loan portfolios, and on the related systems and processes.

To help stakeholders with implementation issues, the IASB has established the IFRS Transition Resource Group for Impairment of Financial Instruments (the ITG).

The ITG held meetings in April, September and December 2015, which we reported in Issue 1, Issue 2 and Issue 3 of our *IFRS Newsletter: IFRS 9 Impairment*. No further meetings are currently planned; however, the ITG remains in place and stakeholders may continue to submit issues.

About the ITG

The purpose of the ITG[2] is to:

- solicit, analyse and discuss stakeholder implementation issues;
- 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.

The ITG does not have standard-setting authority, and its purpose is to advise the IASB. ITG members include representatives from banks and audit firms.

Certain IASB Board members and representatives from the Basel Committee on Banking Supervision and from the International Organization of Securities Commissions (IOSCO) are also observers at the meetings. The meetings are chaired by an IASB Board member.

The ITG's agenda papers, prepared by the IASB staff, and minutes of the meetings are publicly available. All meetings are held in public.

2. The IASB website provides further details on the purpose and activities of the ITG.

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Issues discussed by the ITG to date

22 April 2015

ITG reference	What the ITG discussed
1	The maximum period to consider when measuring ECLs
2	Forecasts of future economic conditions
3	Loan commitments – Scope
4	Revolving credit facilities
4.1	Determining the appropriate life to be used when measuring ECLs
4.2	Determining the date of initial recognition for the purposes of assessing significant increase in credit risk
5	Assessment of significant increase in credit risk for guaranteed debt instruments
6	Measurement of ECLs for an issued financial guarantee contract
7	ECLs – Measurement date
8	Measurement of ECLs in respect of a modified financial asset

16 September 2015

ITG reference	What the ITG discussed
1	Significant increases in credit risk
1.1	Methods of assessing changes in credit risk where loans are priced within broad credit quality bands
1.2	Whether behavioural indicators can be used to identify significant increases in credit risk
2	Use of changes in the risk of default occurring over the next 12 months when assessing for significant increases in credit risk
3	Measurement of ECLs for revolving credit facilities
4	Forward-looking information
4.1	Differentiating forward-looking information
4.2	Determining what is 'reasonable and supportable'

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11 December 2015

ITG reference	What the ITG discussed
1	Incorporation of forward-looking scenarios
1.1	When measuring ECLs can entities use one single forward-looking economic scenario, or do they need to incorporate more than one forward-looking economic scenario and, if so, how?
1.2	How should an entity take into account forward-looking economic scenarios when determining whether there has been a significant increase in credit risk?
2	Scope of paragraph 5.5.20 of IFRS 9
3	Measurement of ECLs for charge cards
4	Period over which to measure ECLs for revolving credit facilities
5	Collateral and other credit enhancements and the measurement of ECLs
6	Inclusion of cash flows expected from sale of a defaulted loan in the measurement of ECLs
7	Meaning of current effective interest rate
8	Assessing for significant increases in credit risk for financial assets with a maturity of less than 12 months
9	Measurement of the loss allowance for credit-impaired financial assets
10	Presentation of the loss allowance for financial assets measured at amortised cost

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Presentation and disclosures

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KPMG contacts

Americas
Reza van Roosmalen
T: +1 212 954 6996
E: rezavanroosmalen@kpmg.com

Dilshad Hassen
T: +1 416 777 8978
E: dhassen@kpmg.ca

Asia-Pacific
Reinhard Klemmer
T: +65 6213 2333
E: rklemmer2@kpmg.com.sg

Tamami Okawa
T: +81 3 3548 5107
E: Tamami.Okawa@jp.kpmg.com

Europe, Middle East and Africa
Colin Martin
T: +44 20 7311 5184
E: colin.martin@kpmg.co.uk

Venkataramanan Vishwanath
T: +91 22 3090 1944
E: vv@kpmg.com

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