ey.com/IFRS

Issue 74 / February 2014

IFRS Developments

IASB completes redeliberations on expected credit loss model; sets 2018 effective date

What you need to know

- The IASB will proceed with the proposed expected credit loss impairment model that is based on 12-month and lifetime expected credit losses (ECL).
- In response to constituents' concerns, the Board has proposed changes to the ECL model and plans to provide further clarification, application guidance and illustrative examples, to help entities with implementation.
- The completed version of IFRS 9 *Financial Instruments*, including classification and measurement, impairment, and hedge accounting requirements, is expected to be issued in the second quarter of 2014 and would be effective for annual periods beginning on or after 1 January 2018.

The IASB plans to issue the completed version of IFRS 9 in the second quarter of 2014 with an effective date from **1 January 2018.**

Highlights

At its February 2014 meeting, the IASB[1] (the Board) completed its redeliberations on the Exposure Draft *Financial Instruments: Expected Credit Losses*[2] (ED). The Board's tentative decisions sought to address the most significant concerns raised by constituents in their comment letters on the ED and during the Board's outreach activities. The key decisions made were to:

- Clarify and provide examples on how to assess significant increases in credit risk
- Clarify how to apply the operational simplifications and modify the description of 'low credit risk'
- Retain 12-month ECL as a measurement basis
- Provide guidance on how 'default' is defined and the inclusion of a 90 days past due rebuttable presumption
- Require ECL to be discounted at the effective interest rate (EIR) or an approximation thereof and the use of the same discount rate for drawn and undrawn loan commitments
- Require ECL to be estimated over the behavioural life for revolving credit facilities
- Link the ECL disclosure objectives and requirements more closely with management's credit risk practices
- Clarify the transition reliefs when applying the ECL model retrospectively

[1] The International Accounting Standards Board.
[2] See *IFRS Developments* Issue 54 for a summary of the IFRS 9 expected credit loss model proposals.

Building a better working world

Summary of the IASB's key tentative decisions

ED proposals	Tentative decisions in redeliberations
Significant increases in credit risk	**Clarification proposed**
At each reporting date (with some exceptions for credit-impaired financial assets, trade and lease receivables), an entity would recognise lifetime ECL for financial instruments if there have been significant increases in credit risk since initial recognition.	The IASB will clarify that: ▶ The objective of the ECL model is to recognise lifetime ECL on all financial instruments when there has been a significant increase in credit risk, whether on an individual or a portfolio basis. ▶ The assessment of significant increases in credit risk could be implemented through a counterparty assessment and/or by establishing the initial maximum origination credit risk accepted (i.e., the level of credit risk accepted at origination) for a portfolio of financial instruments with similar credit risk on initial recognition and comparing it with the credit risk at the reporting date.
Operational simplifications	**Change and clarification proposed**
To simplify the assessment of significant increases in credit risk: ▶ A financial instrument would not meet the criterion for recognising lifetime ECL if it has 'low credit risk', i.e., equivalent to global credit rating of 'investment grade'. ▶ There is a rebuttable presumption that lifetime ECL is required if contractual payments are more than 30 days past due.	The IASB has confirmed that an entity can assume that there has not been a significant increase in credit risk if a financial instrument is deemed to have 'low credit risk'. However, the Board has modified the description of 'low credit risk' (similar wording used by rating agencies to describe 'A' rated assets, one grade higher than was used before), that is: ▶ The instrument has a low risk of 'default'. ▶ The borrower is considered, in the near term, to have a strong capacity to meet its obligations. ▶ The lender expects for the longer term that adverse changes in economic and business conditions may, but not necessarily, reduce the ability of the borrower to fulfil its obligations. The IASB also plans to clarify that a financial instrument does not have to be externally rated and the low credit risk notion is not a bright-line trigger for the recognition of lifetime ECL, i.e., an entity would still need to assess whether there has been a significant increase in credit risk if the financial instrument is no longer deemed to be 'low credit risk'. In addition, the Board has confirmed the more than 30 days past due rebuttable presumption, but will clarify that this is intended to serve as a backstop and should identify significant increases in credit risk before default or objective evidence of impairment.
12-month ECL	**No change proposed**
If the criterion for recognising lifetime ECL is not met, then 12-month ECL would be recognised.	The Board has confirmed the measurement basis of 12-month ECL for financial instruments that have not significantly increased in credit risk.
Definition of default	**Change proposed**
The proposals do not define 'default'.	The IASB will require an entity to apply a 'default' definition that is consistent with its credit risk management practices and to incorporate qualitative indicators of default (e.g., covenants). Furthermore, there will be a rebuttable presumption that default does not occur later than 90 days past due unless an entity has reasonable and supportable information to support a more lagging default definition.
Discount rate	**Change proposed**
When discounting ECL, an entity may choose a discount rate between, and including, the risk-free rate and the EIR.	The Board will require that ECL be discounted at the EIR or an approximation thereof. Also, ECL on the undrawn facility of a loan commitment would be discounted using the same EIR used to discount the ECL on the drawn facility.

ED proposals	Tentative decisions in redeliberations
Loan commitments	**Change proposed**
The ECL model would apply to loan commitments when there is a present contractual obligation to extend credit.	By exception, ECL for revolving credit facilities would be estimated beyond the contractual period over which the entity is committed to provide credit. In particular, an entity would need to consider the behavioural life of revolving credit facilities, i.e., the period over which an entity is exposed to credit risk and where future drawdown cannot be avoided.
Disclosures	**Clarification proposed**
The ED proposed disclosures to enable users to understand an entity's estimate of ECL and changes in the credit risk of financial instruments that include: ▶ Reconciliation of the gross carrying amounts and credit loss allowance balances for financial assets that are credit-impaired on initial recognition, measured at 12-month or lifetime ECL, and at lifetime ECL with objective evidence of impairment ▶ Inputs, assumptions and techniques in estimating ECL ▶ Separate disaggregation by credit risk rating grades of the gross carrying amount for financial assets that are credit-impaired on initial recognition, under the simplified approach, or are measured at 12-month or lifetime ECL ▶ Information about collateral, modified financial assets and write-off policy	**Reconciliation of the gross carrying amount** The Board has retained the requirement to provide a reconciliation of the gross carrying amount and credit loss allowance of financial assets. However, an entity would not be required to provide a detailed reconciliation of the gross carrying amount. Instead, an entity would be required to provide information about the key drivers for changes in the gross carrying amount to the extent that it leads to changes in the credit loss allowance during the period rather than separate lines showing transfers between the measurement categories, or originated, purchased, matured and sold financial assets. **Credit risk disaggregation** The IASB will permit the use of an aging analysis if delinquency is the only borrower-specific information used to assess significant increases in credit risk. Also, an entity would not be required to disaggregate its financial instruments across a minimum of three credit risk rating grades but, instead, should align the credit risk disaggregation with internal credit risk management practices. **Collateral** Qualitative and quantitative information about how collateral and other credit enhancements affect the measurement of ECL would be required, although the fair value of collateral would not be required to be disclosed. **Modified financial assets** The Board has limited the disclosure of the gross carrying amount of financial assets that were previously modified and for which the measurement of the loss allowance has changed from lifetime to 12-month ECL during the period (rather than every reporting date until the assets are derecognised).
Transition	**Clarification proposed**
Retrospective application would be required. However, the following transition reliefs are provided: ▶ No restatement of comparative periods ▶ If determining the initial credit risk would require undue cost or effort, the financial instrument would be evaluated only on the basis of whether it has 'low credit risk' at each reporting date until these assets are derecognised	The IASB has confirmed the requirements in the ED and the transition reliefs, but will clarify that: ▶ The initial credit risk can be approximated based on the best available information that is reasonably available without undue cost or effort. ▶ The initial maximum origination credit risk accepted for a particular portfolio on initial recognition may be used to assess whether there has been a significant increase in credit risk by comparing it with the credit risk at the reporting date. ▶ If assessing significant increases in credit risk is based on days past due, then the more than 30 days past due rebuttable presumption can be applied.

Unchanged from the ED, the Board tentatively confirmed:

- The application of the ECL model to debt instruments measured at amortised cost and at fair value through other comprehensive income
- The simplified approach for trade receivables and lease receivables
- The treatment of purchased or originated credit-impaired financial assets
- The application of the ECL model to modified financial assets
- The measurement of 12-month and lifetime ECL
- The calculation and presentation of interest revenue

Mandatory effective date and interaction with other phases of IFRS 9

The IASB issued new hedge accounting requirements in November 2013[3] and has completed its redeliberations on the impairment and classification and measurement requirements[4].

The completed version of IFRS 9 will include the classification and measurement, impairment and hedge accounting requirements and the Board has tentatively decided that the mandatory effective date of IFRS 9 will be for annual periods beginning on or after 1 January 2018.

Entities will be permitted to apply the impairment requirements early only if the completed version of IFRS 9 is adopted in its entirety. Previous versions[5] of IFRS 9 will no longer be available for early adoption, if the entities' date of initial application is six months or more after the issuance of the completed version of IFRS 9.

How we see it

The mandatory effective date of 2018 will provide sufficient lead time for entities, particularly financial institutions, to develop new systems and processes and to gather historical data and forward-looking information in order to implement the new ECL impairment requirements.

Moreover, the Board will have more opportunity to progress on its insurance contracts project and potentially provide greater alignment between IFRS 9 and the new insurance contracts standard.

Next steps

The completed version of IFRS 9 is expected to be issued in the second quarter of 2014.

The FASB[6] decided to continue to refine the Current Expected Credit Loss (CECL) model and consider feedback received through comment letters and outreach activities on its Exposure Drafts issued. The CECL would require an entity to recognise lifetime expected credit losses on the initial and subsequent measurement of financial instruments in scope. The FASB plans to issue its final credit loss standard in the second half of 2014.

[3] See *IFRS Developments* Issue 68 for a summary of the IFRS 9 hedge accounting requirements.
[4] See *IFRS Developments* Issue 47 for a summary of the IFRS 9 limited amendments to classification and measurement proposals.
[5] IFRS 9 was issued in 2009, 2010 and 2013 which include the classification and measurement of financial assets, the classification and measurement of financial liabilities and the hedge accounting requirements respectively.
[6] The US Financial Accounting Standards Board.

EYG No. AU2196

ED None