STAFF PAPER

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Project	**IFRS Implementation Issues: IFRS 9 *Financial Instruments***		
Paper topic	IFRS 9 Impairment – application of the requirements in paragraph B5.5.40(c) of IFRS 9		
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Introduction

1. Based on our interaction with stakeholders, we have become aware of a question with respect to the application of the impairment requirements of IFRS 9 *Financial Instruments* for instruments within the scope of paragraph 5.5.20 of IFRS 9 such as credit card facilities. Specifically, the question concerns how to apply the requirement in paragraph B5.5.40(c) of IFRS 9 in determining the period over which the entity is expected to be exposed to credit risk, but for which expected credit losses would not be mitigated by the entity's normal credit risk management actions ('the expected life'). This paper primarily comprises extracts from IFRS 9, and the agenda papers for and minutes of the Transition Resource Group for Impairment of Financial Instruments ('the ITG') meetings. Accordingly, this is not a decision-making paper and it does not have any question for the Board.

2. The objective of this paper is:

   (a) to reiterate the relevant requirements in IFRS 9 and confirm the Board's intention behind those requirements; and

   (b) to inform the Board of the Staff's intention to create educational materials relating to this and other areas of implementation challenges should the need arise so as to support the implementation of IFRS 9.

Structure of this paper

3. This paper is structured as follows:

   (a) The relevant requirements of IFRS 9 (paragraph 4-7);

   (b) The relevant consideration in applying these requirements (paragraphs 8-18); and

   (c) Next steps (paragraph 19).

The relevant requirements in IFRS 9

4. When measuring expected credit losses, IFRS 9 generally requires that the maximum period to consider is limited to the maximum contractual period over which the entity is exposed to credit risk and not a longer period, even if that period is consistent with business practice[1]. For some products, for example credit cards, that would have limited the maximum life to a very short period, eg one day. Respondents to the 2013 Impairment Exposure Draft, which did not have any exception to this requirement, raised some concerns[2].

5. Specifically, concerns raised by respondents include:

> **BC5.256** Respondents noted that the use of the contractual period was of particular concern for some types of loan commitments that are managed on a collective basis, and for which an entity usually has no practical ability to withdraw the commitment before a loss event occurs and to limit the exposure to credit losses to the contractual period over which it is committed to extend the credit. […]
>
> **BC5.257** […] in practice, lenders generally continue to extend credit under these types of financial instruments for a duration longer than the contractual minimum and only withdraw the facility if observable credit risk on the facility has increased significantly. […] Consequently,

[1]paragraph of 5.5.19 of IFRS 9

[2]This is reflected in paragraphs BC5.254–BC5.261 of Basis of Conclusions on IFRS 9

> economically, the contractual ability to demand repayment and cancel the undrawn commitment does not necessarily prevent an entity from being exposed to credit losses beyond the contractual notice period.

6. In its deliberation leading to the publication of IFRS 9, the Board reaffirmed that its decision to use the maximum contractual period as the maximum period to consider when measuring expected credit losses was the correct conceptual outcome. However, in acknowledgement of the concerns raised by respondents, the Board decided to include a limited exception to the requirement in paragraph 5.5.19 of IFRS 9 in very specific cases as set out in paragraph 5.5.20 of IFRS 9.

   (a) paragraph 5.5.20 of IFRS 9 introduces a limited exception to the requirements of paragraph 5.5.19 of IFRS 9.

   > **5.5.20** However, some financial instruments include both a loan and an undrawn commitment component and the entity's contractual ability to demand repayment and cancel the undrawn commitment does not limit the entity's exposure to credit losses to the contractual notice period. For such financial instruments, and only those financial instruments, the entity shall measure 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, even if that period extends beyond the maximum contractual period.

   Further application guidance on the general characteristics of such instruments is provided in paragraph B5.5.39; and

   (b) paragraph B5.5.40 of IFRS 9 sets out three particular factors that an entity should consider in determining that period if the financial instruments meet the scope of the exception in paragraph 5.5.20:

   > **B5.5.40** When determining the period over which the entity is expected to be exposed to credit risk, but for which expected credit losses would not be mitigated by the entity's normal credit risk management actions, an entity should consider factors such as historical information and experience about:

(a) the period over which the entity was exposed to credit risk on similar financial instruments;

(b) the length of time for related defaults to occur on similar financial instruments following a significant increase in credit risk; and

(c) the credit risk management actions that an entity expects to take once the credit risk on the financial instrument has increased, such as the reduction or removal of undrawn limits.

7. Determining the appropriate period of exposure is important because it is over that period the risk of default and associated expected credit losses will be measured.

The relevant consideration in applying the relevant requirements

8. In this section, we set out the relevant steps to consider when applying the impairment requirements, in particular in relation to determining the appropriate expected life of particular financial instruments. Much of the discussions in the following paragraphs are reiteration of the requirements in IFRS 9 and those points that have been observed by the members of the Transition Resource Group for Impairment of Financial Instruments ('the ITG'). As each ITG meeting focussed on different aspects of the requirements relating to this area, the staff thinks it would be useful to look at some of the most relevant points together so that their interactions could be better understood.

Determine the scope

9. Firstly, an entity determines whether its financial instruments meet the scope requirement in paragraph 5.5.20 of IFRS 9 considering further requirements in paragraph B5.5.39. If it does, the maximum period to consider will not be limited by the maximum contractual period. The entity determines the period by applying paragraph B5.5.40 of IFRS 9, even if that period extends beyond the maximum contractual period.

10. On the other hand, if a financial instrument does *not* meet the scope requirement of paragraph 5.5.20, paragraph 5.5.19 applies and the maximum period to

consider when measuring expected credit losses is the maximum contractual period. An entity may then determine that the expected life is shorter than the maximum contractual life for example, on the basis of anticipated prepayments.

Apply paragraph B5.5.40

11. The requirements in paragraph B5.5.40 were discussed a number of times by the ITG in its meetings. During its April 2015 meeting, it was highlighted that:

> Entities must consider all three factors set out in paragraph B5.5.40, including the impact of credit risk management actions as required by B5.5.40(c). It was noted that while the exception in paragraph 5.5.20 sets out the specific circumstances under which IFRS 9 requires a period in excess of the maximum contractual period to be used when measuring expected credit losses, the fundamental aim was still to determine the period over which the entity is exposed to credit risk. Consequently, because the entity's ability to take credit risk management actions could result in a shorter period of exposure than that indicated by the behavioural life, it would not be appropriate for an entity to assume that the behavioural life is always equal to the period over which it is exposed to credit risk[3].

12. Said another way, when an entity determines the expected life, an entity considers if, and how its credit risk management actions would result in a shorter expected life than would be the case if the entity considers B5.5.40(a) and (b) only. As noted in paragraph 1, we will focus on how to apply the requirement in paragraph B5.5.40(c) in the following paragraphs but the staff would like to emphasise that when determining the expected life, entities must consider all three factors in paragraph B5.5.40.

The extent of credit risk mitigation

13. In general, entities take credit risk management actions based on internal thresholds set by their own credit risk management policy. For example, an

[3] Paragraph 44 of ITG meeting summary April 2015

entity's policy may be such that the entity blocks an account and removes the unutilised credit limit when the balance is overdue by 60 days. When an account is overdue by *less* than 60 days, the entity's credit risk management policy is that the entity contacts the customers but does not remove the unutilised limit. Although both the removal of the credit limit and contacting the customers are a form of credit risk management actions, the effect they have on the expected life of the facilities differ. Accordingly, when determining the expected life of instruments, such differences in the extent of credit risk mitigation should be considered.

14. Also, if an entity chooses not to take credit mitigation actions although it becomes aware of increase in credit risk, such a decision affects the expected life, and should be considered. For example, Entity A's internal threshold for removing an unutilised credit limit is set at a very high level, ie the entity does not take actions unless the account becomes of a very poor credit grading. Entity B sets that threshold at a lower level of credit risk and removes unutilised limits based on much smaller credit risk increases. Entity A has longer exposures to facilities with increased credit risk. This should be reflected when applying IFRS 9 to these facilities – the credit risk exposure of Entity A would be of longer duration to that of Entity B all else being equal.

Substantive credit review

15. In the December 2015 ITG meeting, a question was asked about whether credit review can be considered as the ending-point of the expected life when applying the requirement in paragraph B5.5.40(c). The ITG members observed that credit review may be the end-point of the expected life (ie it may establish the maximum duration) *if* the entity's normal business practice was to take credit risk mitigation actions as part of the review process. Consequently, it may not always be appropriate to use the timing of the entity's next review process as a basis for determining the ending-point[4].

16. Accordingly, if the entity expects to take credit risk mitigation actions only on *some but not all* instruments that increase in credit risk as described in paragraphs

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[4] Paragraph 42 of ITG meeting summary December 2015

12 and 13 above, that needs to be considered in the analysis. The entity is required to consider the effect of credit management actions to the extent it mitigates credit risk, ie to the extent that such actions are expected to *limit the expected life*. This is consistent with the objective of the requirements in paragraph B5.5.40, which is to determine the period over which the entity is expected to be exposed to credit risk, but *for which expected credit losses would not be mitigated by the entity's normal credit risk management actions.*

17. In addition, an entity's ability to segment and stratify the portfolio into different sections of exposures in accordance with how those exposures are being managed will be relevant[5][6]. For example, an entity may observe through historical information and experience that once there is an increase in credit risk, the life of such facilities become shorter than those that do not. This may be because the entity is more likely to take credit risk mitigation actions on those facilities. This has to be considered when determining expected life. For example, the entity may consider such facilities as a separate segment of the portfolio for the purpose of determining the expected life. Accordingly, when an entity expects a particular portion of the portfolio to increase in credit risk, the entity may determine the expected life of that particular portion separately from those that are not expected to do so, considering expected credit risk management actions that mitigate credit risk. Please see a simplified example in Appendix A for illustration.

The drawn and undrawn components

18. The staff would like to reiterate how the requirements discussed in this paper apply to the drawn and undrawn components. The ITG meeting in December 2013 highlighted the following:

> Consistently with the way in which they are managed, the maximum exposure period to consider in accordance with paragraph B5.5.40 of IFRS 9 applies to both the drawn and undrawn components of a revolving credit facility—ie there is only one maximum exposure period to consider, which applies equally to both components. Nevertheless,

[5] Paragraph 41 of ITG meeting summary April 2015

[6] The relevance of segmentation and stratification of the portfolio has been discussed in the April and December 2015 ITG meetings.

> ITG members acknowledged that, in measuring expected credit losses, credit risk mitigation actions may affect the drawn and undrawn components differently. For example, when an entity cancels the undrawn component, the possibility of any future drawdowns is removed, whereas when an entity demands repayment of the drawn component the recovery period associated with that drawn exposure still needs to be considered in measuring expected credit losses[7].

Next step

19. Given the importance of this matter, the Staff is of the view that it would be beneficial to provide educational material in this area through a webcast.

[7] Paragraph 45 of ITG meeting summary December 2015

Appendix A

A1. We illustrate the discussions set out in this paper using a simplified example.

A2. Consider an entity has a portfolio consisting 100 facilities. The entity performs credit reviews on an annual basis and these are substantive credit reviews that are followed by credit risk mitigation actions.

A3. Based on historical information and experience, the entity estimates the following:

(a) 30 out of 100 facilities are expected to increase in credit risk by the next review date.

(b) The entity expects to take credit mitigation actions on 15 out of 30 that increase in credit risk. The undrawn component of the 15 facilities is expected to be removed.

A4. As the entity expects 30 out of 100 facilities are to increase in credit risk, the entity would determine the expected life of the 30 facilities separately from the other 70 facilities.

A5. Out of the 30 facilities, the entity expects to remove the undrawn component for 15 of them. In accordance with paragraph B5.5.40(c), the expected life will be shortened for the half of the facilities in that segment (ie 15 facilities) to the extent the undrawn component exists.

A6. The expected life of the remaining 15 facilities in the segment will be determined considering the requirements in paragraphs B5.5.40(a) and B5.5.40(b).

A7. Similarly, the expected life of the 70 facilities will be determined based on historical information and experience on similar financial instruments in accordance with paragraphs B5.5.40(a) and B5.5.40(b).