Introduction

1. This paper addresses an issue raised by a submitter regarding the application of the impairment requirements of IFRS 9 *Financial Instruments* (2014). Specifically, the issue relates to the scope of paragraph 5.5.20 of IFRS 9.

2. This paper:

   (a) sets out the relevant accounting requirements in IFRS 9 and IFRS 7 *Financial Instruments: Disclosures*;

   (b) summarises the potential implementation issue raised by the submitter; and

   (c) asks the members of the Transition Resource Group for Impairment of Financial Instruments (‘the ITG’) for their views on the issue identified.
Accounting requirements

3. Paragraph 5.5.19 of IFRS 9 stipulates that the maximum period to consider when measuring expected credit losses is the maximum contractual period (including extension options) over which the entity is exposed to credit risk and not a longer period, even if that period is consistent with business practice.

4. However, as noted in paragraphs BC5.254–BC5.261 of IFRS 9¹, respondents to the 2013 Impairment Exposure Draft raised concerns in relation the requirement in paragraph 5.5.19 of IFRS 9 for specific financial instruments such as revolving credit and overdraft facilities that are managed on a collective basis. Some of the typical characteristics of these financial instrument are described below [emphasis added]:

   **BC5.256** Respondents also noted that those revolving credit facilities lack a fixed term or repayment structure and allow borrowers flexibility in how frequently they make drawdowns on the facility. Such facilities can be viewed as a combination of an undrawn loan commitment and a drawn-down loan asset. Typically, these facilities can be contractually cancelled by a lender with little or no notice, requiring repayment of any drawn balance and cancellation of any undrawn commitment under the facility. There would be no need on a conceptual basis to recognise expected credit losses on the undrawn portion of these facilities, because the exposure period could be as little as one day under the proposals in the 2013 Impairment Exposure Draft.

5. In considering these concerns, the IASB noted that respondents stated that in practice, the entity’s credit risk may not be limited to the contractual notice period

¹ Appendix A reproduces paragraphs BC5.254–BC5.261 of IFRS 9 in their entirety.
in some circumstances. The IASB also observed that because of the way in which these financial instruments were managed, only one set of cash flows from the borrower was considered (in relation to the drawn and undrawn portions) and expected credit losses were estimated on a facility level. Consequently, the IASB noted that the period over which the expected credit losses are estimated should reflect the period over which the entity is expected to be exposed to the credit risk on the instrument as a whole [emphasis added]:

**BC5.259** The IASB further noted that from a credit risk management perspective, the concept of expected credit losses is as relevant to off balance sheet exposures as it is to on balance sheet exposures. **These types of financial instruments include both a loan (ie financial asset) and an undrawn commitment (ie loan commitment) component and are managed, and expected credit losses are estimated, on a facility level.** In other words there is **only one set of cash flows from the borrower that relates to both components.** Expected credit losses on the on balance sheet exposure (the financial asset) are not estimated separately from the expected credit losses on the off balance sheet exposure (the loan commitment). Consequently, **the period over which the expected credit losses are estimated should reflect the period over which the entity is expected to be exposed to the credit risk on the instrument as a whole.**

6. As noted in paragraphs BC5.260-BC5.261 of IFRS 9, the IASB reaffirmed its decision to use the maximum contractual period as the maximum period to consider when measuring expected credit losses. This is the approach in IFRS 9 except that the IASB decided to include a limited exception to this principle in very specific cases in acknowledgement of the concerns raised by respondents about paragraphs BC5.254–BC5.257 of IFRS 9 [emphasis added]:
BC5.260 The IASB remains of the view that the contractual period over which an entity is committed to provide credit (or a shorter period considering prepayments) is the correct conceptual outcome. The IASB noted that most loan commitments will expire at a specified date, and if an entity decides to renew or extend its commitment to extend credit, it will be a new instrument for which the entity has the opportunity to revise the terms and conditions. Consequently, the IASB decided to confirm that the maximum period over which expected credit losses for loan commitments and financial guarantee contracts are estimated is the contractual period over which the entity is committed to provide credit.

BC5.261 However, to address the concerns raised about the financial instruments noted in paragraphs BC5.254–BC5.257, the IASB decided that for financial instruments that 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, an entity shall estimate expected credit losses over the period that the entity is expected to be 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. When determining the period over which the entity is exposed to credit risk on the financial instrument, the entity should consider factors such as relevant historical information and experience on similar financial instruments. The measurement of expected credit losses should take into account credit risk management actions that are taken once an exposure has increased in
credit risk, such as the reduction or withdrawal of undrawn limits.

7. Consequently, the following exception to the requirement set out in paragraph 5.5.19 of IFRS 9 is included in paragraph 5.5.20 of IFRS 9 [emphasis added]:

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.

8. Paragraph B5.5.39 of IFRS 9 provides further application guidance that describes the characteristics generally associated with the type of financial instruments described in paragraph 5.5.20 of IFRS 9 [emphasis added]:

B5.5.39 However, in accordance with paragraph 5.5.20, 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 example, revolving credit facilities, such as credit cards and overdraft facilities, can be contractually withdrawn by the lender with as little as one day's notice. However, in practice lenders continue to extend credit for a longer period and may only withdraw the facility after the credit risk of the borrower increases, which could be too late to prevent some or all of the expected credit
losses. These financial instruments **generally have the following characteristics** as a result of the nature of the financial instrument, the way in which the financial instruments are managed, and the nature of the available information about significant increases in credit risk:

(a) the financial instruments **do not have a fixed term or repayment structure** and usually have a short **contractual cancellation period** (for example, one day);

(b) the **contractual ability to cancel the contract is not enforced in the normal day-to-day management** of the financial instrument and the contract may only be cancelled when the entity becomes aware of an **increase in credit risk at the facility level**; and

(c) the financial instruments are managed on a **collective basis**.

9. During the April 2015 ITG meeting, some ITG members requested clarification regarding the scope of paragraph 5.5.20 of IFRS 9. Paragraphs 36 and 37 of the April ITG meeting notes summarise the ITG discussions on this point:

**36** Some ITG members requested clarification of the exception outlined in paragraph 5.5.20 of IFRS 9. Specifically, they asked whether it could be applied to the example presented by analogising the 6-month mortgage loan to a revolving credit facility that has been fully drawn at the reporting date.

**37** In this regard, it was noted that paragraph 5.5.20 of IFRS 9 applies to financial instruments with a drawn and undrawn component where the borrower has flexibility in how frequently they make drawdowns on the facility and consequently it is possible that the facility could be fully drawn or fully undrawn at the reporting date. It was also highlighted that the Basis of Conclusions of IFRS 9
provides further context around the types of financial instruments that were envisaged would fall under the scope of paragraph 5.5.20 i.e. revolving credit facilities such as credit cards and overdraft facilities. However, in the example presented, the facility is not of a revolving nature and the borrower does not have any such flexibility regarding drawdowns. Consequently, it would not be appropriate to analogise to the financial instruments described in paragraph 5.5.20 of IFRS 9.

10. Paragraph 35B of IFRS 7 sets out the objectives of credit risk disclosures and, more specifically, paragraph 35B(a) of IFRS 7 notes that credit risk disclosures shall provide information about an entity’s credit risk management practices and how they relate to the recognition and measurement of expected credit losses and paragraph 35G of IFRS 7 requires an entity to explain, amongst other things, the assumptions used to measure expected credit losses. In addition, paragraph 35E of IFRS 7 notes that in order to meet the objective of credit risk disclosures, an entity may be required to disclose additional information:

**35E** If the disclosures provided in accordance with paragraphs 35F–35N are insufficient to meet the objectives in paragraph 35B, an entity shall disclose additional information that is necessary to meet those objectives.

**Potential implementation issue identified**

11. The submitter observes that in accordance with paragraph 5.5.20 of IFRS 9, the type of financial instruments within its scope are described as those that 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.\(^2\) The submitter also observes that the application guidance set out in paragraph B5.5.39 of IFRS 9 goes on to set out what are considered to be the general characteristics of such financial instruments and specifically notes that one of those characteristics is that these financial instruments do not have a fixed term or repayment structure.

12. The submitter asks whether the general characteristics described in paragraph B5.5.39 of IFRS 9 should be considered to be *required* characteristics, or merely examples of typical characteristics, when determining whether a particular financial instrument would fall within the scope of paragraph 5.5.20 of IFRS 9. In particular, the submitter focusses on the characteristic relating to the term and repayment structure of the financial instrument as set out in paragraph B5.5.39(a) of IFRS 9.

13. In order to illustrate the issue the submitter describes a number of different types of credit facilities that a lender might provide to both its retail and corporate customers. Some of the typical characteristics of these facilities identified by the submitter are set out below:

<table>
<thead>
<tr>
<th>Lenders often advance multi-purpose revocable credit facilities to customers, both retail and corporate. Typical characteristics of these facilities include:</th>
</tr>
</thead>
<tbody>
<tr>
<td>• a fixed limit which can be used in a number of different ways, for example, a revolving overdraft, a variable or fixed rate loan (with or without a fixed term), an amortising loan such as a mortgage etc;</td>
</tr>
<tr>
<td>• facilities are typically advanced on a secured basis with the same collateral covering all products within the facility;</td>
</tr>
<tr>
<td>• there is often a maximum limit that can be allocated to any revolving product within the facility; during the life of the facility the revolving product limit rebalances (up to the set maximum limit) as any amortising products within the facility are paid off;</td>
</tr>
</tbody>
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\(^2\) The submitter acknowledges that the scope of paragraph 5.5.20 of IFRS 9 was previously discussed at the April 2015 ITG meeting (see paragraph 9) but observes that the ITG did not discuss the question of scope within the context of more complex facilities.
14. The submitter notes that in accordance paragraph B5.5.39(a) of IFRS 9, one of the general characteristics listed for the financial instruments falling within the scope of paragraph 5.5.20 of IFRS 9 is that these financial instruments do not have a fixed term or repayment structure. In this regard, the submitter questions whether either of the following characteristics would prevent a facility from being within the scope of paragraph 5.5.20 of IFRS 9:

(i) if an immediately revocable (ie at the discretion of the lender) facility has a fixed maturity eg 5 years; or

(ii) if an immediately revocable facility has no fixed maturity but when drawn, can take the form of a loan with a fixed maturity, eg 5 years (ie once drawn, the lender no longer has the right to demand immediate repayment at its discretion).

15. In respect of the question above, the submitter considers that if the general characteristics set out in paragraph B5.5.39 of IFRS 9 are considered to be required characteristics then this may result in a more narrow application of the
scope of paragraph 5.5.20 of IFRS 9, which sets out a more general description of the nature of the financial instruments falling within its scope.³

Review of accounting requirements

16. We note that paragraph 5.5.20 of IFRS 9 introduces an exception to the requirements of paragraph 5.5.19 of IFRS 9 in respect of the period to consider when measuring expected credit losses for specific financial instruments such as revolving credit and overdraft facilities that are managed on a collective basis. As explained in paragraphs BC5.254–BC5.257 of IFRS 9, respondents were concerned that if the requirements of paragraph 5.5.19 of IFRS 9 were applied to these financial instruments, this would result in expected credit losses being measured over a very short period, which would not reflect the underlying economics or the way in which these facilities were managed.

17. We also observe that the exception set out in paragraph 5.5.20 of IFRS 9 was intended to be limited in nature. This is illustrated by the wording in paragraph 5.5.20 of IFRS 9, which states that the exception applies to ‘such financial instruments and only those financial instruments’ and in the supporting discussions set out in paragraphs BC5.254–BC5.261 of IFRS 9. Specifically, the IASB noted that:

(a) it remains of the view that the contractual period over which an entity is committed to provide credit (or a shorter period considering prepayments) is the correct conceptual outcome (see paragraph BC5.260 of IFRS 9); and

(b) the exception in paragraph 5.5.20 of IFRS 9 was introduced in order to address the concerns raised by respondents in paragraphs

³ The submitter observes that there may be a more fundamental question, concerning the unit of account, in respect of facilities of the type described in paragraph 13.
BC5.254-BC5.257 of IFRS 9 in relation to very specific types of financial instruments (see paragraph BC5.261 of IFRS 9).

18. In order to determine whether a financial instrument falls within the scope of paragraph 5.5.20 of IFRS 9, we note that an entity would be required to consider the description set out in paragraph 5.5.20 of IFRS 9 together with the supporting application guidance in paragraph B5.5.39 of IFRS 9.

19. Paragraph 5.5.20 of IFRS 9 describes the financial instruments within its scope as those that include both a loan and undrawn commitment component and in which 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. Consequently, we observe that in order for a financial instrument to be within the scope of paragraph 5.5.20 of IFRS 9, there are a number of criteria which need to be met. Specifically, the financial instrument must have all of the following characteristics:

(a) the financial instrument must be of a type that has the ability to have both a loan and undrawn commitment components;

(b) the entity must have the contractual ability to demand repayment of the loan component and cancel the undrawn commitment component; and

(c) despite the entity’s contractual ability referred to in (b) above, the entity’s exposure to credit losses is not limited to the contractual notice period.

20. We note that paragraph B5.5.39 of IFRS 9 repeats the description set out in paragraph 5.5.20 of IFRS 9 and goes on to describe the characteristics generally associated with the financial instruments within its scope, which, when considered together, are consistent with that description.

21. Specifically, paragraph B5.5.39 of IFRS 9 notes that the financial instruments within the scope of paragraph 5.5.20 of IFRS 9 generally have the following characteristics:
(a) no fixed term or repayment structure and usually a short contractual cancellation period (for example, one day). We note that this feature supports the characteristics set out in paragraph 19(b) above—ie irrespective of whether the facility is drawn or undrawn, contractually it can be cancelled at short notice. We observe that this characteristic is also consistent with the IASB’s understanding of the way in which these financial instruments were managed, ie as noted in paragraph 5 only one set of cash flows from the borrower was considered (in relation to the drawn and undrawn portions) and expected credit losses were estimated on a facility level. We observe that if a financial instrument had a fixed term, eg 5 years, and could not be cancelled at short notice then in the absence of any other information to the contrary, that fixed term (subject to prepayments) would be the appropriate period over which to measure expected credit losses because this would appropriately represent the period over which the entity was exposed to credit risk;

(b) the contractual ability to cancel the contract is not enforced in the normal day-to-day management and the contract may only be cancelled when the entity becomes aware of an increase in credit risk at the facility level. We note that if the entity did routinely enforce its contractual ability to cancel the contract as part of its normal day-to-day management, then in the absence of any other information to the contrary, the contractual period over which the entity was exposed to credit risk would be the appropriate period over which to measure expected credit losses; and

(c) managed on a collective basis. We note that if the financial instruments were being managed on an individual basis, then there would not seem

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4 As noted in paragraph BC5.255 of IFRS 9, the concerns expressed by respondents regarding the contractual period related to financial instruments that were managed on a collective basis and for which the entity usually had no practical ability to withdraw the commitment before a loss event occurred.
to be any reason why the entity would not be in a position to routinely enforce its contractual ability to cancel the contract. Again, if this were the case, then in the absence of any other information to the contrary, the contractual period over which the entity was exposed to credit risk would be the appropriate period over which to measure expected credit losses.

22. Furthermore, as noted in the April ITG meeting summary (see paragraph 9 above) the Basis for Conclusions of IFRS 9 (see paragraphs BC5.254-BC5.261 of IFRS 9) also provides further context about the types of financial instruments that were envisaged to fall under the scope of paragraph 5.5.20 of IFRS 9. In this regard, we note that in paragraph BC5.259 of IFRS 9 the IASB observed that the financial instruments falling within the scope of paragraph 5.5.20 include both a loan (ie financial asset) and an undrawn commitment (ie loan commitment) component and are managed, and expected credit losses are estimated, on a facility level.

23. Within the context of the types of multi-purpose credit facilities described by the submitter, we observe that an entity would be required to determine the unit of account to which the impairment requirements of IFRS 9 should be applied. Having made that determination, paragraph 5.5.20 of IFRS 9 and the related application guidance would need to be considered at that level, including assessing all of the specific characteristics of each facility, including how each facility was managed, in order to determine whether that particular financial instrument would fall within the scope of paragraph 5.5.20 of IFRS 9.

24. In respect of the two specific questions raised by the submitter in paragraph 14 regarding whether a 5-year fixed term characteristic would prevent a financial instrument from falling within the scope of paragraph 5.5.20 of IFRS 9, we make the following observations:

(a) a credit facility (ie an undrawn loan commitment) that has a fixed term eg 5 years but is immediately revocable without cause. As noted in
paragraph 19(b), one of the characteristics of facilities falling within the scope of paragraph 5.5.20 of IFRS 9 is that the entity has the contractual ability to cancel the undrawn commitment component. In this example, although the facility has a maximum period of availability of 5 years, this does not negate the lender’s contractual ability to cancel the undrawn commitment. Consequently, given the presence of the revocable feature, the fact that the loan commitment is dated would not seem inconsistent with the type of facility described in paragraph 5.5.20 of IFRS 9; and

(b) a credit facility (ie an undrawn loan commitment) that is immediately revocable but once drawn the repayment terms become fixed, eg 5 years, and the lender cannot demand repayment at any time. As noted in paragraph 19(b), one of the characteristics of facilities falling within the scope of paragraph 5.5.20 is that the entity has the contractual ability to demand repayment of the loan component and consequently, this particular fixed-term characteristic would seem inconsistent with the type of facility described in paragraph 5.5.20 of IFRS 9. Consequently, it is noted that for drawn portions of the credit facility described, the maximum period to consider when measuring expected credit losses would be 5 years (subject to any prepayment considerations).

25. However, as noted in paragraph 23, irrespective of the contractual terms of the facility, an entity would be required to assess all of the characteristics of a facility, including how that facility was managed, in order to determine whether it would fall within the scope of paragraph 5.5.20 of IFRS 9.

26. Finally, we note that in order to meet the objectives of credit risk disclosures described in paragraph 35B of IFRS 7, an entity must provide information about its credit risk management practices and how they relate to the recognition and measurement of expected credit losses and that in accordance with paragraph 35G of IFRS 7, an entity is required to explain the assumptions used to measure
expected credit losses. Within the context of the more complex multi-purpose credit facilities described by the submitter in paragraph 13, we observe that these disclosures would be important. In addition, in accordance with paragraph 35E of IFRS 7, an entity should also be mindful of whether it is necessary to disclose additional information in order to meet the overall objectives of credit risk disclosures.

Question for ITG members

What are your views on the issue presented above?
Appendix A

Extracts from the Basis for Conclusions of IFRS 9

BC5.254 Respondents to the 2013 Impairment Exposure Draft widely supported the proposed requirements for loan commitments and financial guarantee contracts in general, and no new arguments were raised that the IASB considered would call into question its prior analysis. However, the majority of respondents that supported including loan commitments within the scope of the proposed model noted that expected credit losses on some loan commitments should be estimated over the behavioural life of the financial instrument, instead of over the contractual commitment period. Although they noted that the use of the contractual period would be conceptually appropriate, there was concern that using the contractual period:

(a) would be contrary to how the exposures are handled for credit risk management and regulatory purposes;

(b) could result in insufficient allowances for the exposures arising from these contracts; and

(c) would result in outcomes for which no actual loss experience exists on which to base the estimates.

BC5.255 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. Respondents noted that this applies particularly to
revolving credit facilities such as credit cards and overdraft facilities. For these types of facilities, estimating the expected credit losses over the behavioural life of the instruments was viewed as more faithfully representing their exposure to credit risk.

**BC5.256** Respondents also noted that those revolving credit facilities lack a fixed term or repayment structure and allow borrowers flexibility in how frequently they make drawdowns on the facility. Such facilities can be viewed as a combination of an undrawn loan commitment and a drawn-down loan asset. Typically, these facilities can be contractually cancelled by a lender with little or no notice, requiring repayment of any drawn balance and cancellation of any undrawn commitment under the facility. There would be no need on a conceptual basis to recognise expected credit losses on the undrawn portion of these facilities, because the exposure period could be as little as one day under the proposals in the 2013 Impairment Exposure Draft.

**BC5.257** Outreach performed during the comment period on the 2013 Impairment Exposure Draft indicated that, 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. The IASB noted that, for such facilities, the contractual maturities are often set for protective reasons and are not actively enforced as part of the normal credit risk management processes. Participants also noted that it may be difficult to withdraw undrawn commitments on these facilities for commercial reasons unless there has been an increase in credit risk. Consequently, 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.

**BC5.258** The IASB noted that the expected credit losses on these type of facilities can be significant and that restricting the recognition of a loss allowance to expected credit losses in the contractual notice period would arguably be inconsistent with the notion of expected credit losses (ie it would not reflect actual expectations of loss) and would not reflect the underlying economics or the way in which those facilities are managed for credit risk purposes. The IASB also noted that the amount of expected credit losses for these facilities could be significantly lower if the exposure is restricted to the contractual period, which may be inconsistent with an economic assessment of that exposure.

**BC5.259** The IASB further noted that from a credit risk management perspective, the concept of expected credit losses is as relevant to off balance sheet exposures as it is to on balance sheet exposures. These types of financial instruments include both a loan (ie financial asset) and an undrawn commitment (ie loan commitment) component and are managed, and expected credit losses are estimated, on a facility level. In other words there is only one set of cash flows from the borrower that relates to both components. Expected credit losses on the on balance sheet exposure (the financial asset) are not estimated separately from the expected credit losses on the off balance sheet exposure (the loan commitment). Consequently, the period over which the expected credit losses are estimated should reflect the period over which the entity is expected to be exposed to the credit risk on the instrument as a whole.
BC5.260 The IASB remains of the view that the contractual period over which an entity is committed to provide credit (or a shorter period considering prepayments) is the correct conceptual outcome. The IASB noted that most loan commitments will expire at a specified date, and if an entity decides to renew or extend its commitment to extend credit, it will be a new instrument for which the entity has the opportunity to revise the terms and conditions. Consequently, the IASB decided to confirm that the maximum period over which expected credit losses for loan commitments and financial guarantee contracts are estimated is the contractual period over which the entity is committed to provide credit.

BC5.261 However, to address the concerns raised about the financial instruments noted in paragraphs BC5.254–BC5.257, the IASB decided that for financial instruments that 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, an entity shall estimate expected credit losses over the period that the entity is expected to be 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. When determining the period over which the entity is exposed to credit risk on the financial instrument, the entity should consider factors such as relevant historical information and experience on similar financial instruments. The measurement of expected credit losses should take into account credit risk management actions that are taken once an exposure has increased in
credit risk, such as the reduction or withdrawal of undrawn limits.