Practical Workshop for NBU Staff and Bankers

Impairment
IFRS 9

Shamim Diouman
Consultant, CFRR,
the World Bank

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CFRR》
Centre for Financial Reporting Reform

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IMPAIRMENT

Introduction

» IFRS 9 has a single method of impairment.

» Conceptually more principles based than IAS 39.

» What does it mean for banks?

» Is IFRS 9 impairment more simple than IAS 39?

Forward looking impairment model

» The model requires an entity to **recognise expected credit losses at all times and to update the amount of expected credit losses recognised at each reporting date to reflect changes in the credit risk of financial instruments.**

» This model is forward-looking and it eliminates the threshold for the recognition of expected credit losses, so that it is no longer necessary for a trigger event to have occurred before credit losses are recognised. Consequently, more timely information is required to be provided about expected credit losses.

Forward looking impairment model

» Furthermore, when credit losses are measured in accordance **with IAS 39, an entity may only consider those losses that arise from past events and current conditions. The effects of possible future credit loss events cannot be considered, even when they are expected.** The requirements in IFRS 9 broaden the information that an entity is required to consider when determining its expectations of credit losses.

» Specifically, IFRS 9 requires an entity to base its measurement of expected credit losses **on reasonable and supportable information that is available without undue cost or effort, and that includes historical, current and forecast information.**

Single impairment model

» *In addition, under IFRS 9 the same impairment model is applied to all financial instruments that are subject to impairment accounting, removing a major source of current complexity. This includes financial assets classified as amortised cost and fair value through other comprehensive income, lease receivables, trade receivables, and commitments to lend money and financial guarantee contracts.*

3 stages

» A single "3-stage model" based on changes in credit quality.

» Stage 1: Performing (Initial recognition)

» Stage 2: Under-performing (Assets with significant increase in credit risk since inception)

» Stage 3: Non-performing (Credit impaired assets)

3 Stages

Stage 1	Stage 2	Stage 3
Impairment Recognition		
12 month expected credit losses	**Lifetime expected credit losses**	**Lifetime expected credit losses**
Interest Revenue Effective interest on gross carrying amount	Effective interest on gross carrying amount	Effective interest on amortised cost

Increase in Credit Risk since initial recognition

Stage 1

» As soon as a financial instrument is originated or purchased, **12-month expected credit losses** are recognised in profit or loss and a loss allowance is established.

» 12-month ECL are the expected credit losses that result from default events that are possible within 12 months after the reporting date.

» This serves as a proxy for the initial expectations of credit losses.

» For financial assets, interest revenue is calculated on the gross carrying amount (i.e. without adjustment for expected credit losses).

Stage 2

» If the credit risk increases significantly **and** the resulting credit quality is not considered to be low credit risk, full lifetime expected credit losses are recognised.

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» The calculation of interest revenue on financial assets remains the same as for Stage 1.

Stage 3

» If the credit risk of a financial asset increases to the point that it is considered credit-impaired, interest revenue is calculated based on the amortised cost (ie the gross carrying amount adjusted for the loss allowance). **Financial assets in this stage will generally be individually assessed.**

» Lifetime expected credit losses are still recognised on these financial assets.

Expected losses

12-month expected credit losses

» 12-month expected credit losses are the portion of lifetime expected credit losses that represent the expected credit losses that result from default events on a financial instrument that are possible within the 12 months after the reporting date: CREDIT LOSS on an asset weighted by the probability that the loss will occur in the next 12 months.

» It is NOT the expected cash shortfalls over the next twelve months—instead, it is the effect of the entire credit loss on an asset weighted by the probability that this loss will occur in the next 12 months.

» *It is also NOT the credit losses on assets that are forecast to actually default in the next 12 months. If an entity can identify such assets or a portfolio of such assets that are expected to have increased significantly in credit risk, lifetime expected credit losses are recognised.*

Lifetime expected credit losses

» Lifetime expected credit losses are an expected present value measure of losses that arise if a borrower defaults on their obligation throughout the life of the financial instrument. They are the weighted average credit losses with the probability of default as the weight.

» 12-month expected credit losses are the portion of the lifetime expected credit losses associated with the possibility of a default in the next twelve months.

» Because expected credit losses consider the amount and timing of payments, a credit loss (ie cash shortfall) arises even if the entity expects to be paid in full but later than when contractually due.

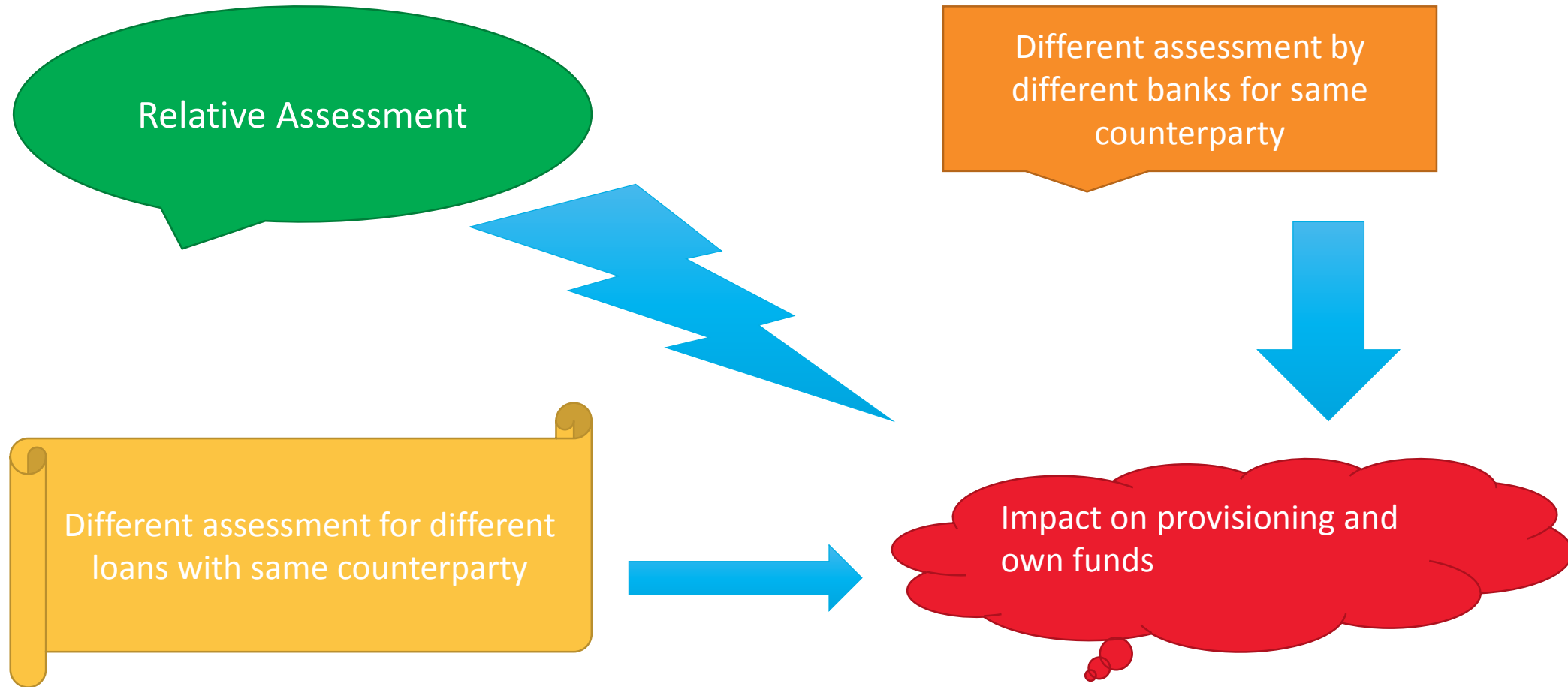# What should an entity consider when measuring expected credit losses?

» Credit losses are the present value of all cash shortfalls. Expected credit losses are an estimate of credit losses over the life of the financial instrument. When measuring expected credit losses, an entity should consider:

» the probability-weighted outcome: expected credit losses should represent neither a best or worst-case scenario. Rather, the estimate should reflect the possibility that a credit loss occurs and the possibility that no credit loss occurs;

» the time value of money: expected credit losses should be discounted to the reporting date; and

» reasonable and supportable information that is available without undue cost or effort.

Assessment by management

The standard requires management, when determining whether the credit risk on a financial instrument has increased significantly, to consider reasonable and supportable information available, in order to compare the risk of a default occurring at the reporting date with the risk of a default occurring at initial recognition of the financial instrument.

Assessment by management

Relative Assessment

Different assessment by different banks for same counterparty

Different assessment for different loans with same counterparty

Impact on provisioning and own funds

Use of information

» An entity is required to use reasonable and supportable information that is available at the reporting date without undue cost or effort, and that includes information about past events, current conditions and forecasts of future conditions.

» IFRS 9 does not prescribe particular measurement methods. Also, an entity may use various sources of data that may be internal (entity-specific) and external.

Use of information

» Although the model is forward-looking, historical information is always considered to be an important anchor or base from which to measure expected credit losses. However, historical data should be adjusted on the basis of current observable data to reflect the effects of current conditions and forecasts of future conditions.

Probability of default

» In stage 2: Expected credit losses are the weighted average credit losses with the probability of default ('PD') as the weight.

» From stage 1 to stage 2: An entity should compare the risk of a default as at the reporting date with the risk of a default occurring on the financial instrument as at the date of initial recognition.

» **Management can choose to make the assessment by using PD, generally a lifetime PD (over the remaining life of the instrument) should be used. (Please keep in mind for next session)**

» However, as a practical expedient, a 12-month PD can be used if it is not expected to give a different result to using lifetime PDs. (cf to regulatory rules in next session).

Probability of default

» PD: The probability of default of a borrower over a one-year horizon.

» LGD: The loss given default as a percentage of exposure at default.

» EAD: Exposure at default (an amount, not a percentage).

» M: Maturity

» For a given maturity, these parameters are used to estimate two types of expected loss (EL).

» Expected loss as an amount:

» EL = PD(%) × LGD(%) × EAD($)

» Expected loss as a percentage of exposure at default:

» EL% = PD(%) × LGD(%)

Significant increase in credit risk

Performing

Under performing

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Stage 1                          Stage 2
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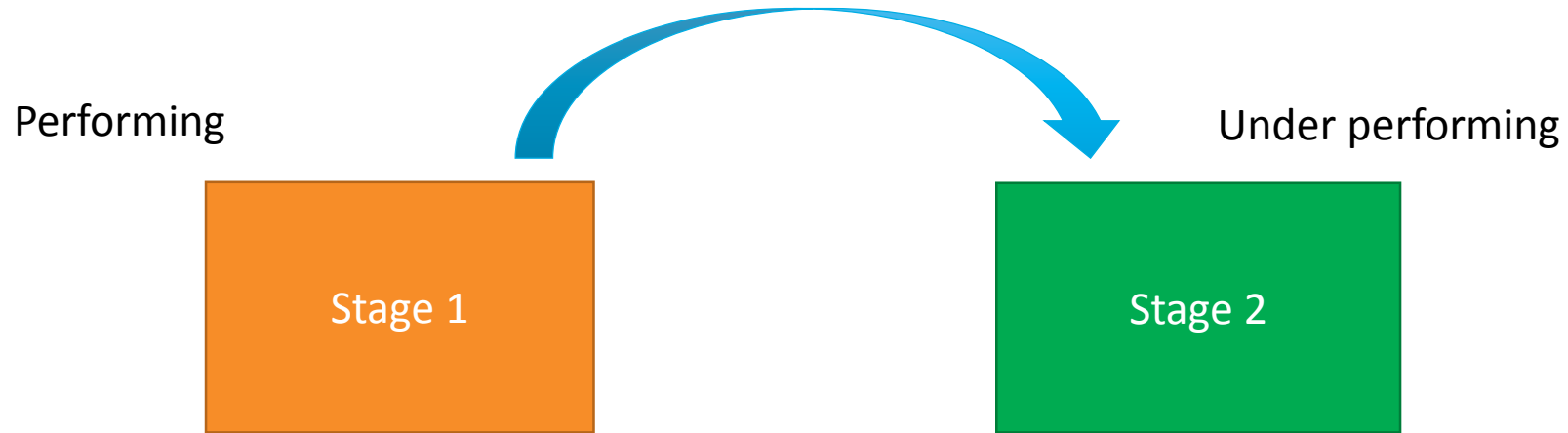
» In order to perform the assessment all information available should be taken into account.

» When the financial instrument is collateralized, entities should assess significant increases in credit risk without taking into account the collateral.

» Nevertheless, when calculating ECL, the expected recovery from collateral should be taken into account.

Significant increase in credit risk

| Collateral | ≠ | Low Risk |

» The credit risk of the instrument needs to be evaluated without consideration of collateral. **This means that financial instruments are not considered to have low credit risk simply because that risk is mitigated by collateral**.

» Financial instruments are also not considered to have low credit risk simply because they have a lower risk of default than the entity's other financial instruments or relative to the credit risk of the jurisdiction within which the entity operates.

Significant increase in credit risk

| Change in low credit risk | ≠ | Include in Stage 2 |

» The low credit risk simplification is not meant to be a bright-line trigger for the recognition of lifetime ECL. Instead, when credit risk is no longer low, management should assess whether there has been a significant increase in credit risk to determine whether lifetime ECL should be recognized.

» This means that just because an instrument's credit risk has increased such that it no longer qualifies as low credit risk, it is not automatically included in Stage 2, Management needs to assess if a significant increase in credit risk has occurred before calculating lifetime ECL for the instrument.

Significant increase in credit risk

» When assessing whether the credit risk on a financial instrument has increased significantly since initial recognition, management looks at the change in the risk of a default occurring over the expected life of the financial instrument rather than the change in the ECL.

» An entity should compare the risk of a default as at the reporting date with the risk of a default occurring on the financial instrument as at the date of initial recognition.

Comparing PDs

» Management should be aware that a simple or absolute comparison of PDs at initial recognition and at the reporting date is not appropriate. All other things staying constant, the PD of a financial instrument should reduce with the passage of time.

» So, management needs to consider the relative maturities of a financial instrument at inception and at the reporting date when comparing PDs. This means that the PD for the remaining life of a financial asset at the reporting date (for example, two years if three years have already passed on a five-year instrument) should be compared to the PD expected at initial recognition for the last two years of its maturity (that is, for years 4 and 5).

» This requirement could be operationally challenging.

Assessing credit risk

» When determining whether the credit risk on an instrument has increased significantly, management should consider reasonable and supportable best information available without undue cost or effort. This information should include actual and expected changes in external market indicators, internal factors and borrower-specific information.

» Examples of ways in which the assessment of significant increases in credit risk could be implemented more simply include:

> » Establishing the initial maximum credit risk for a **particular portfolio by product type and/or region** (the 'origination credit risk') and comparing that to the credit risk at the reporting date. This would only be possible for portfolios of financial instruments with similar credit risk on initial recognition;
>
> » Assessing increases in credit risk through a counterparty assessment, as long as such assessment achieves the objectives of the proposed model; and
>
> » An actual or expected significant change in the financial instrument's external credit rating.

Different phases in credit risk

» Generally **a financial instrument would have a significant increase in credit risk before there is objective evidence of impairment or before a default occurs.**

» The standard requires both forward-looking and historical information to be used in order to determine whether a significant increase in credit risk has occurred.

Different phases in credit risk

Too late for accounting provisioning

Credit risk increase → Objective evidence of impairment → Default

IFRS 9

IAS 39
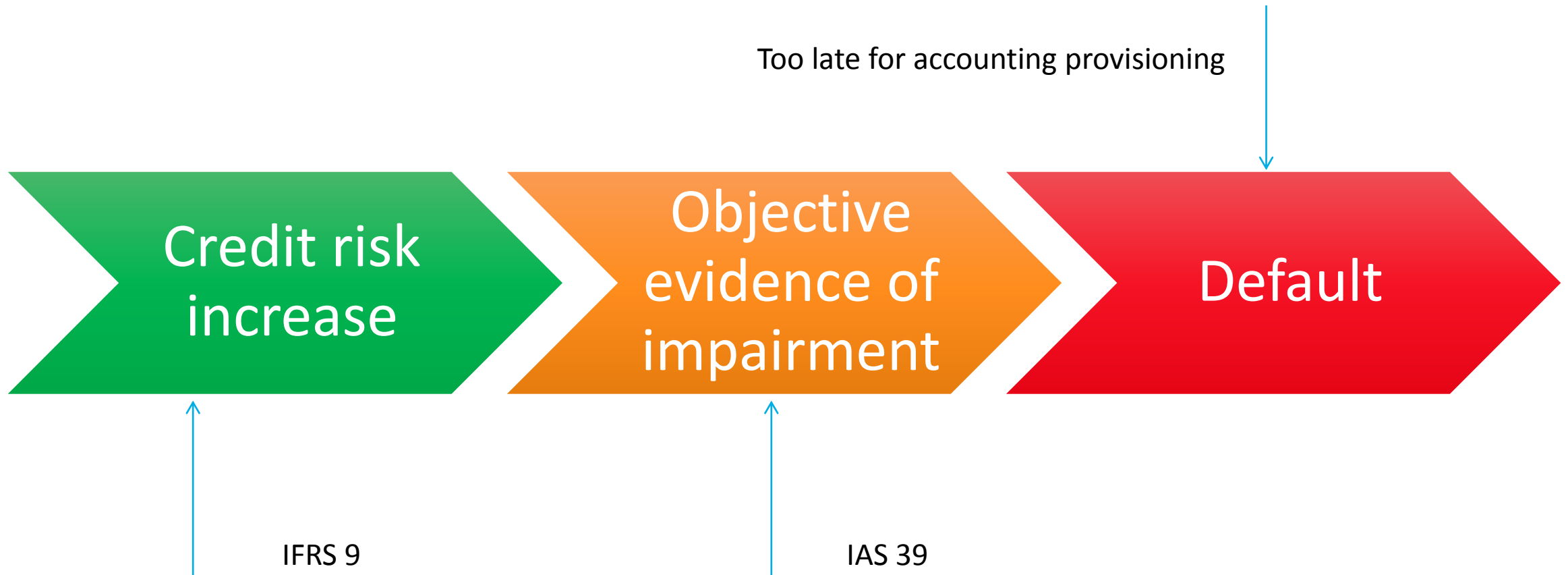
30 days rebuttable presumption

» Lifetime ECL are expected to be recognized before a financial asset becomes delinquent. If forward-looking information is reasonably available, an entity cannot rely solely on delinquency information when determining whether credit risk has increased significantly since initial recognition; it also needs to consider the forward-looking information.

» However, if information that is more forward-looking than past due status is not available, there is a rebuttable presumption that credit risk has increased significantly since initial recognition no later than when contractual payments are more than 30 days past due.

30 days rebuttable presumption

» **This presumption can be rebutted if there is reasonable and supportable evidence that, regardless of the past-due status, there has been no significant increase in the credit risk**: For example, where non-payment is an administrative oversight, instead of resulting from financial difficulty of the borrower.

» Another example is where management has access to historical evidence that demonstrates that there is no correlation between significant increases in the risk of a default occurring and financial assets on which payments are more than 30 days past due, but that evidence does identify such a correlation when payments are more than 60 days past due.

Instrument/portfolio levels

» The model can be applied at an individual or portfolio level. However, some factors or indicators may not be identifiable at an instrument level. In such cases, the factors or indicators should be assessed at a portfolio level. Management cannot avoid calculating lifetime ECL by considering the assessment at an individual asset level only, if information available at portfolio level indicates that there has been an increase in credit risk for the instruments included in the portfolio.

» Depending on the nature of the financial instrument and the credit risk information available for particular groups of financial instruments, management might not be able to identify significant changes in credit risk for individual financial instruments before the financial instrument becomes past due. This might be the case for financial instruments, such as retail loans, for which there is little or no updated credit risk information that is routinely obtained and monitored on an individual instrument basis until a customer breaches the contractual terms.

Instrument/portfolio levels

» If changes in the credit risk for individual financial instruments are not captured before they become past due, a loss allowance based only on credit information at an individual financial instrument level would not faithfully represent the changes in credit risk since initial recognition.

» In some circumstances management does not have reasonable and supportable information that is available without undue cost or effort to measure lifetime ECL on an individual instrument basis.

» In that case, lifetime ECL should be recognized on a collective basis that considers comprehensive credit risk information.

Instrument/portfolio levels

» This comprehensive credit risk information must incorporate not only past-due information but also all relevant credit information, including forward-looking macro-economic information, in order to approximate the result of recognizing lifetime ECL when there has been a significant increase in credit risk since initial recognition on an individual instrument level.

» Management can group financial instruments on the basis of shared credit risk characteristics with the objective of facilitating an analysis that is designed to enable significant increases in credit risk to be identified on a timely basis. The entity should not obscure this information by grouping financial instruments with different risk:

Instrument/portfolio levels

» Examples of shared credit risk characteristics might include, but are not limited to:

  » the instrument type;
  » the credit risk ratings;
  » the collateral type;
  » the date of origination;
  » the remaining term to maturity;
  » the industry;
  » the geographical location of the borrower; and
  » the value of collateral relative to the commitment if it has an impact on the
  » probability of a default occurring (for example, non-recourse loans in some jurisdictions or loan-to-value ratios).

Measuring ECL

» ECL are a probability-weighted estimate of credit losses. A credit loss is the difference between the cash flows that are due to an entity in accordance with the contract and the cash flows that the entity expects to receive discounted at the original effective interest rate. Because ECL consider the amount and timing of payments, a credit loss arises even if the entity expects to be paid in full but later than when contractually due.

Present value of contractual cash flows

Present value of cash flows the entity expects to receive

Measuring ECL

» For loan commitments, the maximum period over which ECL should be measured is the maximum contractual period over which the entity is exposed to credit risk.

» Some financial instruments include both a loan and an undrawn commitment component, such as revolving credit facilities. In such cases, the contractual ability to demand repayment and cancel the undrawn commitment does not necessarily limit the exposure to credit losses beyond the contractual period. For those financial instruments, management should measure ECL over the period that the entity is exposed to credit risk and ECL would not be mitigated by credit risk management actions, even if that period extends beyond the maximum contractual period.

Measuring ECL

» The time value of money must be taken into account when calculating the ECL (regardless of whether it is the 12-month or the lifetime ECL). Management should discount the cash flows that it expects to receive at the effective interest rate determined at initial recognition, or an approximation thereof in order to calculate ECL. If a financial instrument has a variable interest rate, ECL should be discounted using the current effective interest rate.

» When calculating ECL on financial assets classified in the FVOCI category, movements in the ECL provision will impact profit or loss ('P&L'). Under the model, impairment charges in P&L will always occur earlier as compared to current IAS 39 guidance, and this is no different for financial assets classified in the FVOCI category.

Measuring ECL

» The standard establishes that management should measure expected credit losses over the remaining life of a financial instrument in a way that reflects:

  » an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes;

  » the time value of money; and

  » reasonable and supportable information about past events, current conditions and reasonable and supportable forecasts of future events and economic conditions at the reporting date.

Measuring ECL

» When estimating ECL, management should consider information that is reasonably available, including information about past events, current conditions and reasonable and supportable forecasts of future events and economic conditions. **The degree of judgment that is required for the estimates depends on the availability of detailed information.**

» As the forecast horizon increases, the availability of detailed information decreases, and the degree of judgment to estimate ECL increases. The estimate of ECL does not require a detailed estimate for periods that are far in the future – for such periods, management may extrapolate projections from available, detailed information.

Collateral

» For measuring ECL, the estimate of expected cash shortfalls should reflect the cash flows expected from collateral and other credit enhancements that are part of the contractual terms and are not recognized separately by the entity.

» The estimate of expected cash shortfalls on a collateralized financial instrument reflects the amount and timing of cash flows that are expected from foreclosure on the collateral less the costs of obtaining and selling the collateral. This is irrespective of whether foreclosure is probable (that is, the estimate of expected cash flows considers the probability of a foreclosure and the cash flows that would result from it). Consequently, any cash flows that are expected from the realization of the collateral beyond the contractual maturity should be included in this analysis. Any collateral obtained as a result of foreclosure is not recognized as an asset that is separate from the collateralized financial instrument unless it meets the relevant recognition criteria for an asset.

Conclusion

» IFRS 9 is conceptually less complex than IAS 39.

  » Single model of impairment and less categories.

» IFRS 9 impairment aligned with loan loss provisioning in Basel III and CRR.

» However, IFRS 9 still requires "a lot of" judgment.

» There are key differences between IFRS 9 expected losses and loan loss provisioning in Basel III and CRR.