IFRS NEWSLETTER

IFRS 9 IMPAIRMENT

Issue 2, September 2015

cutting through complexity

ITG members emphasised the importance of considering forward-looking information and making clear disclosures about expected credit loss estimates.

ITG tackles some difficult areas of judgement

This *IFRS Newsletter* highlights the ITG's discussions on the impairment requirements of IFRS 9 *Financial Instruments* in September 2015.

The new expected credit loss (ECL) model for the impairment of financial instruments has triggered a variety of implementation issues.

At its second substantive meeting – in September 2015 – the IFRS Transition Resource Group for Impairment of Financial Instruments (the ITG) discussed a number of issues that were submitted by stakeholders.

The main points raised at the meeting were as follows.

- ITG members appeared to agree that internal credit risk ratings and behavioural indicators may be valuable tools in applying the new standard.
- IASB Board members explained their belief that estimates of expected credit losses on revolving credit facilities should not include losses on expected draw-downs that exceed contractual credit limits.
- Entities will need to consider how to incorporate relevant forward-looking information into their estimates. The nature of inputs and models used for this purpose are likely to evolve over time.
- Disclosures are important in explaining how estimates have been made – including whether any relevant factors have been excluded.
- A representative of the Basel Committee on Banking Supervision reported that its final guidance on accounting for ECLs would be published before the end of 2015, and explained the changes that it was making in response to comments received.

For each issue submitted, the IASB will consider what action – if any – is required.

The ITG's next meeting is planned for 11 December 2015. The deadline for submissions is 21 October 2015.

ITG DISCUSSIONS AT A GLANCE

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).

In April 2015, the ITG held its first substantive meeting, which we reported in our IFRS Newsletter: IFRS 9 Impairment – Issue 1. Its second substantive meeting, which is the subject of this newsletter, was held in September 2015.

About the ITG

The purpose of the ITG[1] 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, are publicly available and all meetings are held in public. Minutes of the meeting will also be made publicly available.

An index of issues discussed by the ITG since its inception can be found on page 19.

What happened in September 2015?

The following Agenda Papers submitted to the ITG were discussed at the September meeting.

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The IASB staff reported that they were analysing an additional issue on the accounting for collateral by the holder of a financial asset. This concerns the meaning of collateral and other credit enhancements being "part of the contractual terms" when measuring ECLs.

They expect to present this issue to the ITG at the next ITG meeting in December.

The ITG also received an update on the Basel Committee's proposals on accounting for ECLs, which is discussed on page 18.

On most issues, members of the group generally appeared to agree on the interpretation of the standard. In some cases, they provided further clarifications to help preparers implement the requirements.

The issue generating most conceptual debate related to the meaning of a 'contractual term' when it concerns a revolving credit facility (Agenda Paper 3).

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

Future ITG meetings

The next ITG meeting is planned for 11 December 2015. The deadline for stakeholders to submit issues for discussion is 21 October 2015.

The Chair encouraged stakeholders to submit issues before that deadline, so that the ITG could consider them on a timely basis, thereby contributing to a stable platform for constituents to work from as they prepare for implementation.

Currently, no further physical ITG meetings are scheduled beyond the end of 2015. However, the Chair indicated that the ITG will continue to exist and should stand ready in case any subsequent issues for discussion emerge.

Next steps

The IASB staff announced that they would bring to the next IASB meeting a log of issues – separate from those discussed in the Agenda Papers – that might require additional guidance in the standard, and discuss whether such guidance is needed. These issues were not included in the agenda for the ITG meetings because the ITG does not have standard-setting authority.

For each issue submitted, the IASB will consider what action – if any – is required.

Descriptive and summary statements in this newsletter are based on notes that have been taken in observing the IFRS Transition Resource Group for Impairment of Financial Instruments (the ITG). They are not intended to be a substitute for the final texts of the relevant records or the official summaries or minutes of ITG discussions which may not be available at the time of publication and which may differ. Entities should consult the texts of any requirements they apply and the official summaries of Board meetings and ITG meetings, and seek the advice of their accounting and legal advisors.

1. SIGNIFICANT INCREASES IN CREDIT RISK

1.1 Methods of assessing changes in credit risk where loans are priced within broad credit quality bands

What's the issue?

Under the general impairment model in IFRS 9, measurement of ECLs depends on whether there has been a significant increase in the credit risk of a financial instrument since its initial recognition[2]. Accordingly, at each reporting date, an entity should compare the risk of default at initial recognition of an instrument with the risk of default at the reporting date.

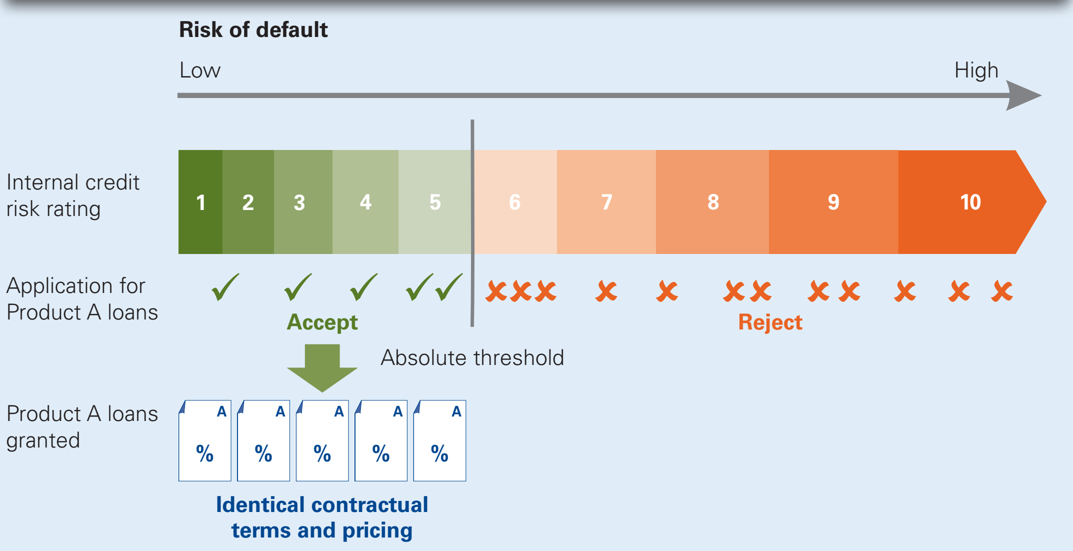
The standard gives examples of information relevant to assessing changes in credit risk[3]. This includes information on the pricing of similar products at the reporting date – i.e. credit risk may have increased if a similar financial instrument with the same terms and the same counterparty, and newly originated at the reporting date, would have a higher credit-related pricing element.

The basis for conclusions to IFRS 9[4] also notes that significant increases in credit risk could be assessed more simply for portfolios of financial instruments with similar credit risk at initial recognition by:

- determining the maximum credit risk accepted for a particular portfolio on initial recognition; and
- comparing the credit risk of financial instruments in that portfolio at the reporting date to that maximum credit risk.

The stakeholder submitting this issue provided a fact pattern that is illustrated below.

Illustration – Bank X's credit risk rating model



Bank X holds a portfolio of individual loans and assigns an internal credit risk rating from 1 to 10 to each loan, with 1 denoting the lowest credit risk and 10 denoting the highest credit risk. The credit risk grades include all available information about the customer. The assessed risk of default occurring increases exponentially from one grade to the next – meaning that the assessed difference in the risk of default between Grades 1 and 2 is smaller than that between Grades 2 and 3, etc.

2. Paragraphs 5.5.3 and 5.5.5 of IFRS 9.
3. Paragraph B5.5.17 of IFRS 9.
4. Paragraph BC5.161 of IFRS 9.

There are various types of retail loan products in Bank X's portfolio, including Product A. The maximum credit risk rating the bank will accept for Product A is 5. Once a loan application is accepted, the contractual terms and pricing are identical for all customers taking the product. Consequently, although the credit risk grades of the Product A loans may range from 1 to 5 at origination, all of these loans have the same contractual terms.

The following questions were posed to the ITG.

- Is it appropriate for Bank X to use a single absolute threshold to determine whether there has been a significant increase in credit risk – e.g. a breach of a specific credit risk grade?
- Alternatively, are there any other approaches that would be more appropriate – e.g. defining a significant increase in credit risk as an increase by a certain number of credit risk grades since initial recognition?

ITG members appeared to agree that internal credit risk ratings may be a valuable tool in applying the new standard.

ITG members appeared to agree that a single absolute threshold could not be used to identify significant increases in credit risk for loans that did not have similar credit risk at initial recognition.

What did the ITG discuss?

Issue	ITG discussion
Is it appropriate to use changes in credit risk grades to identify significant deterioration in credit risk?	**ITG members appeared to agree on the following.** **Appropriateness of using credit risk grades** It may be possible to use changes in credit risk grades to identify significant increases in credit risk. However, there are many different types of credit risk rating systems used in practice. The appropriateness of using changes in risk grades would depend on whether, and to what extent, changes in risk grades reflect changes in credit risk – i.e. the lifetime risk of default, for this purpose. For example, for some products and rating systems, a certain change in credit risk grade might imply only a change in the risk of default over the short term, but have little impact on the risk of default over the expected life of the instrument. **Assessing the credit risk rating system** An internal credit risk rating system needs to be assessed, to ascertain whether it is an appropriate model for identifying a significant increase in credit risk. This includes considering whether the allocation of risk grades takes into account all relevant, reasonable and supportable information, including forward-looking information. For example, if the rating system does not consider forward-looking information, it may not be appropriate to use it, or it may need to be supplemented by additional individual or collective assessment that considers forward-looking, macro-economic or other relevant information that is not adequately captured in the assignment of ratings. This concern may be more pronounced for retail portfolios where there is generally less information available about borrowers on an individual basis than about corporate exposures, for which more in-depth individual analysis to support credit risk grades may be possible.

Issue	ITG discussion
Is it appropriate to use changes in credit risk grades to identify significant deterioration in credit risk? (continued)	Therefore, different criteria for identifying significant deteriorations in credit risk may be appropriate for different portfolios and in different circumstances. It is important to consider whether portfolios are appropriately segmented, taking into account the degree of homogeneity of exposures and their sensitivity to different macro-economic factors. This also applies for any additional collective assessment.
Is it appropriate to use an absolute threshold for the assessment of significant deterioration in credit risk?	**ITG members appeared to agree on the following.** **Objective of the assessment** The objective of the assessment is to identify relative increases in credit risk – i.e. a significant increase in credit risk at the reporting date relative to that at initial recognition. **Appropriateness of using an absolute threshold** In view of the objective, the use of an absolute threshold could be appropriate only if the loans had similar credit risk at initial recognition, such that increases in credit risk below the threshold grade would not be significant. In the submitted example, this would mean that a deterioration in credit risk rating from Grade 1 to Grade 5 would have to be considered not significant for an absolute threshold to be used. This would seem implausible for a 10-grade rating model. In particular, an entity could not conclude that such a change did not represent a significant increase in credit risk by considering only the contractual terms and pricing of the loans. The entity should consider all available evidence. **A Basel Committee representative made the following comments** Bank X's underwriting and pricing policies may lead to a problem of adverse selection – i.e. most new borrowers would tend to be concentrated at the bottom end of its acceptable rating range. There is a risk that credit problems in the portfolio might not be detected on an individual exposure basis, and that a form of collective assessment would also be required.

Issue	ITG discussion
Could alternative approaches based on an increase in a certain number of credit risk grades since initial recognition be appropriate?	**ITG members appeared to agree on the following.** **Calibration of the rating system** The answer to this issue would depend on the factors discussed above, including the calibration of the rating system. IFRS 9 states that a smaller absolute change in the risk of default occurring will be more significant for a higher-quality asset than for a lower-quality asset. When using a credit risk rating model where a deterioration in rating of one notch represents an exponential increase in the risk of default across the range of ratings, it is more likely that a significant increase in credit risk could be determined by an equivalent number of notch movements for both higher and lower credit risk assets. When using a credit risk rating model where a deterioration in rating of one notch represents a linear increase in the risk of default across the range of ratings, an asset with lower credit risk at initial recognition would probably require fewer notch movements to be considered to have undergone a significant increase in credit risk than would an asset with a higher credit risk at initial recognition.

1.2 Whether behavioural indicators can be used to identify significant increases in credit risk

What's the issue?

IFRS 9 requires an entity to compare the risk of default at initial recognition of an instrument with the risk of default at the reporting date[5]. The issue submitted to the ITG noted that this requirement is a very challenging aspect of implementing the IFRS 9 impairment guidance – particularly for revolving credit facilities such as credit cards and residential secured lines of credit.

Therefore, the submitter asked whether the assessment of significant increase in credit risk could be made on the basis of behavioural indicators. These could include a customer's:

- making only the minimum monthly repayment for a specified number of months;
- failing to make a payment on a loan with a different lender; or
- failing to make a specified number of minimum monthly repayments.

The submitter noted that such an approach could be viewed as using absolute indicators, because it is not an explicit comparison with the risk of default occurring at initial recognition of an instrument.

The submitter also considered that such behavioural indicators could be used to demonstrate that a financial instrument has a low credit risk at the reporting date – i.e. it qualifies for the low credit risk exception under IFRS 9[6].

5. Paragraphs 5.5.3 and 5.5.5 of IFRS 9.
6. Paragraph 5.5.10 of IFRS 9.

ITG members appeared to agree that behavioural indicators may be an ingredient in the assessment of significant increases in credit risk.

What did the ITG discuss?

Issue	ITG discussion
What information should be considered?	**ITG members made the following comments.** **Available information** IFRS 9 requires that all reasonable and supportable information that is available without undue cost or effort should be used. This may include behavioural indicators. As noted previously, particularly for retail portfolios, there may be limited available information about individual borrowers. Therefore, for these portfolios, behavioural information might have to play a more significant role in the assessment and may be more widely used. **Using behavioural indicators** Whether and how particular behavioural indicators are used should depend on how they are correlated with changes in the lifetime risk of default – i.e. whether they are a reasonable proxy for changes in credit risk. Entities may develop more sophisticated behavioural scoring models based on multiple indicators. These models, and their calibration, would be expected to be refined over time. Behavioural indicators are more powerful if they can be used to identify increases in credit risk prior to delinquency. However, behavioural indicators such as those identified in the submission tend to be lagging indicators of increases in credit risk. It is important to consider how behavioural indicators would be supplemented by an evaluation of macro-economic factors and forward-looking information in order to identify significant deterioration in credit risk on a timely basis. IFRS 9 states that past-due information may be used in some circumstances. It also introduces a rebuttable presumption that a significant increase in credit risk has occurred when financial assets are more than 30 days past due. An assessment based on behavioural indicators cannot be used to over-ride the rebuttable presumption unless an entity has reasonable and supportable information that demonstrates that the credit risk has not increased significantly since initial recognition. The extent and availability of behavioural information may vary across portfolios. Some of the behavioural indicators included in the submission may not be very useful or meaningful for products with back-ended payment obligations. Relevant information from third parties – e.g. credit bureaux – should be considered when it is available without undue cost or effort. However, such information is not available in all jurisdictions. Behavioural indicators of the types identified in the submission would not support a conclusion that an instrument qualifies for the low credit risk exception.

2. USE OF CHANGES IN THE 12-MONTH PD FOR THE ASSESSMENT

What's the issue?

Under IFRS 9, assessing whether the credit risk of a financial instrument has increased significantly is based on changes in the risk of a default occurring over the expected life of an instrument[7]. However, in some cases the standard indicates that it may be reasonable to use changes in the 12-month probability of default (PD) instead – i.e. the risk of default occurring over the next 12 months.

For example, IFRS 9 states that changes in the 12-month PD may be a reasonable approximation of changes in the lifetime risk of default for financial instruments whose default patterns are not concentrated at a specific point during their life[8]. The basis for conclusions to IFRS 9 also notes that in general, changes in the 12-month PD should be a reasonable approximation of changes in the lifetime risk of default[9].

The submitter asked whether an entity would be required to review annually whether using the 12-month PD was, or is still, appropriate – and if so, to what extent.

The submitter presented three potential approaches for an annual review.

Approach	What the approach involves
Quantitative	Annual calculation and comparison of the lifetime PD and the 12-month PD.
Qualitative	Annual qualitative review. If that review concluded that the use of 12-month PD was no longer appropriate, the entity would have to use the lifetime PD.
Recalibration	Top-down review of factors that have the greatest impact on the appropriateness of using the 12-month PD, which would then be adjusted to reflect these factors.

ITG members appeared to agree that using the 12-month PD as a reasonable approximation of the lifetime PD requires an appropriate level of analysis.

What did the ITG discuss?

Issue	ITG discussion
How much and what kind of analysis is required?	**ITG members made the following comments.** **Amount of analysis** An appropriate level of analysis is required to support using changes in the 12-month PD to determine whether credit risk has increased significantly. The analysis should be revisited and updated as appropriate at each reporting date. The amount of analysis required will depend on the circumstances. Assessment and reassessment may be made on an on-going basis – e.g. using a more detailed initial analysis, with reassessment focusing on whether there have been changes to the key factors and circumstances identified in the initial analysis that would indicate that using 12-month PDs would no longer be appropriate.

7. Paragraph 5.5.9 of IFRS 9.
8. Paragraph B5.5.13 of IFRS 9.
9. Paragraph BC5.178 of IFRS 9.

Issue	ITG discussion
How much and what kind of analysis is required? (continued)	**Type of analysis** The objective of the analysis is to determine whether *changes* in the 12-month PD are a reasonable proxy for *changes* in the lifetime risk of default. Analyses might be performed on a segmented basis – i.e. by referring to groups of exposures with similar characteristics. When new exposures are originated, it may be necessary to determine that they have similar characteristics to other exposures for which 12-month PDs are used. The standard does not generally require calculation of an explicit lifetime PD to identify significant increases in credit risk. Therefore, the standard does not require a quantitative comparison of 12-month PD vs lifetime PD as a matter of routine. However, it may be important to consider available quantitative information about lifetime PDs in performing the analysis – e.g. if these are calculated for assets that are transferred to Stage 2. Even if the quantitative assessment was performed, simple comparison of the lifetime PD with the 12-month PD, as suggested in the submission, would not achieve the objective of the guidance. This is because the two measures are not compatible (as they relate to different lengths of period) and the comparison would not look at *changes*.
What should be borne in mind when considering using 12-month PDs?	**ITG members made the following comments.** **Appropriateness of using the 12-month PD** Use of the 12-month PD is a proxy for assessing significant increases in credit risk – it is not a proxy for measuring lifetime ECLs. Whether the 12-month PD is an appropriate proxy depends on the nature of the exposure, including its maturity and relevant circumstances. A 12-month PD may be an appropriate proxy if expected default patterns are not concentrated at a specific point during the instrument's expected life. By contrast, a 12-month PD may not be a good proxy if economic factors are expected to have significantly different impacts on default risk over time – e.g. if unemployment is a key driver of default risk and the entity expects significantly different unemployment rates over the next 12 months compared with the overall expected life of the instrument. The standard explicitly cautions that the 12-month PD may not be a suitable proxy if changes in economic factors may have only a relatively small impact on the 12-month PD, but a more pronounced impact on the lifetime PD. However, the 12-month PD also may not be a good proxy if short-term economic factors lead to a relatively large increase in the 12-month PD but little proportionate impact on the lifetime PD.

Issue	ITG discussion
What should be borne in mind when considering using 12-month PDs? (continued)	**Other considerations** If it is no longer appropriate to use the 12-month PD, another appropriate method for identifying changes in lifetime credit risk needs to be identified. However, as noted above, the standard does not generally require calculation of an explicit lifetime PD. In some cases, entities might use modified 12-month PDs or supplement them with overlays to better capture macro-economic changes and forward-looking information. One ITG member noted that some entities may seek to use 12-month PDs on (and shortly after) adoption of the new standard and then move to more sophisticated approaches as they enhance their models and data sets over time. Disclosures provide useful information on how the assessment of significant increases in credit risk is made, and how forward-looking information has been incorporated.

3. MEASUREMENT OF ECLs FOR REVOLVING CREDIT FACILITIES

What's the issue?

IFRS 9 states that the maximum period over which ECLs are measured is the maximum contractual period (including extension options) over which the entity is exposed to credit risk – a longer period is not used even if that longer period is consistent with business practice[10].

However, an exception applies for financial instruments:

- that contain both a loan and an undrawn commitment component; and
- for which the entity's contractual ability to demand payment and cancel the undrawn commitment does not limit its exposure to the contractual notice period[11].

When the exception applies, the entity measures ECLs over the period for which:

- the entity is exposed to credit risk; and
- ECLs would not be mitigated by credit risk management actions,

even if that period extends beyond the contractual period.

The standard requires an entity's estimate of ECLs on loan commitments to be consistent with its expectations of draw-downs on that loan commitment. The stakeholder submitting this issue observed that in practice the contractual credit limit on revolving credit facilities – e.g. credit cards and bank overdrafts – is often exceeded when a customer defaults. They noted that the exception refers only to a time horizon and does not state whether expected drawdowns in excess of the contractual limits should be included in the measurement of ECLs.

The question asked was whether expected drawdowns that exceed a customer's contractual limit should be taken into account when estimating ECLs on revolving credit facilities.

The Chair and other IASB Board members present believed that an entity is not permitted to consider expected draw-downs in excess of the contractual credit limit.

What did the ITG discuss?

Issue	ITG discussion
Should expected draw-downs in excess of contractual limits be included when measuring ECLs?	**ITG members appeared to agree on the following.** ITG members appeared to agree that the exception in IFRS 9: • refers only to extending the time horizon beyond the contractual notice period; and • does not provide guidance on whether expected draw-downs in excess of contractual limits should be included when measuring ECLs. **ITG members also made the following comments.** Some ITG members noted that credit risk management for revolving credit facilities at banks generally looks at behavioural aspects that include both expected tenors and expected amounts – therefore, it would consider expected draw-downs in excess of advised contractual limits. Regulatory calculations would take a similar perspective. Consequently, a discrepancy would arise between the accounting treatment and industry practices when applying the exception.

10. Paragraph 5.5.19 of IFRS 9.
11. Paragraph 5.5.20 of IFRS 9.

Issue	ITG discussion
Should expected draw-downs in excess of contractual limits be included when measuring ECLs? (continued)	Some ITG members also observed that draw-downs under a facility in excess of the contractual limit may still be cash flows arising under the contract with the customer, and might give rise to expected cash shortfalls as described in the standard. The Chair emphasised that the purpose of the ITG is to discuss implementation issues based on the published standard, not to discuss changing the standard. The Chair and other IASB members present at the meeting believed that an entity is not permitted to consider expected draw-downs in excess of the contractual credit limit agreed with the customer – i.e. the amount that the entity is contractually committed to advance – when measuring ECLs. This is because the standard requires that ECLs should generally be based on the contractual terms of the commitment unless a specific exemption applies.
What is a 'contractual credit limit' when it relates to a revolving credit facility?	**ITG members debated the following.** There was a more general debate over what a 'contractual term' means when it relates to a revolving credit facility. The following observations were made by several ITG members. • The identification of contractual terms may differ from jurisdiction to jurisdiction. • In some cases, the contractual terms of a revolving credit facility may not include an absolute credit limit. – For some charge cards, there may be no predetermined credit limit specified in the contract. – For some checking accounts, overdrafts are permitted entirely at the bank's discretion. The contract may not include a limit even though it refers to the fees and interest payable if the account is overdrawn. • The analysis of these limitations may require further thought.

4. FORWARD-LOOKING INFORMATION

4.1 Differentiating forward-looking information

What's the issue?

The issue submitted to the ITG asked whether forward-looking information should be incorporated in a differentiated way for different entities and portfolios.

The submitter concluded that forward-looking indicators and scenarios should be weighted and differentiated by entity and by portfolio.

ITG members appeared to agree that forward-looking information should be incorporated in a differentiated way.

What did the ITG discuss?

Issue	ITG discussion
How should forward-looking information be differentiated?	**ITG members appeared to agree on the following.** Different forward-looking information has different relevance and significance for different portfolios. Therefore, forward-looking information should be incorporated in a differentiated way that is appropriate in the circumstances. Entities would generally be expected to apply methodologies by entity and by portfolio, and to implement them in a comparable and consistent manner.

4.2 Determining what is 'reasonable and supportable'

What's the issue?

The issue submitted to the ITG asked how an entity determines what constitutes reasonable and supportable forward-looking information. The submitter noted that there are different sources of forward-looking information, including the following.

- Macro-economic assumptions and forecasts, and other more detailed data, that an entity uses for budgeting and forecasting purposes.
- Other forward-looking information on emerging issues and uncertain future events that is not usually included in the entity's budgeting and forecasting processes – e.g. the Scottish referendum in 2014 or a possible Greek exit from the Eurozone.

The submitter proposed a structured approach to identifying reasonable and supportable forward-looking information and including it when measuring ECLs.

ITG members appeared to agree that the objective in measuring ECLs is to determine a probability-weighted estimate of credit losses.

Each entity should establish its own specific approach for identifying forward-looking information.

'Reasonable and supportable information' is relevant information determined by evaluating the full range of possible outcomes.

What did the ITG discuss?

Issue	ITG discussion
What is the objective of using forward-looking information in measuring ECLs?	**ITG members made the following comments.** The objective in measuring ECLs is to determine a probability-weighted estimate of credit losses. This estimate should reflect all reasonable and supportable information, including forward-looking information that is relevant and is available without undue cost and effort at the reporting date. (As part of this exercise, relevant forward-looking information is also used in determining whether the credit risk of financial assets has increased significantly.)
How is forward-looking information incorporated when measuring ECLs?	**ITG members made the following comments.** **Approaches to measurement** Entities should determine their own approach that is consistent with achieving this objective. Approaches to measurement are expected to evolve over time as entities obtain more experience in applying the standard. Entities should ensure that their approach is subject to appropriate governance and controls. A possible event or outcome should not be ignored solely because it is considered to be remote, since a probability-weighted estimate reflects the full range of possible outcomes. However, the likelihood of an event does affect whether it might have a material impact on probability-weighted estimates of ECLs. **Overlays** Overlays to a modelling approach may be required to obtain reasonable and supportable information about the effects of emerging economic themes or possible future economic shocks if these effects are not otherwise reflected in the ECL estimate. The use of overlays should be assessed in relation to the objective in measuring ECLs. Therefore, the nature and extent of overlays will depend on the loss experiences and estimates embedded in pre-overlay model outputs. It is important to avoid double-counting or inappropriate extrapolation. For example, historical data or base case estimates may already reflect information about previous economic shocks or themes. An overall analysis might consider whether there would be significant differences between these starting estimates and new estimates that incorporate specific adjustments that both add new relevant factors and remove ones that are no longer relevant. Entities should stand back and consider whether the final result is consistent with the objective set out above. Overlays may be performed at a collective level, especially for retail portfolios. Again, care is required to avoid double-counting of factors. For example, if the credit rating of a corporate exposure is downgraded based on forward-looking information, and the corresponding individual ECL estimate increased accordingly, then it would not be appropriate to make an additional collective allowance based on the same forward-looking information.

Issue	ITG discussion
How is forward-looking information incorporated when measuring ECLs? (continued)	**Other considerations** ECLs are based on the entity's estimates, and entities are expected to have a reasonable basis and explanation for their estimates of future macro-economic variables. However, such forecasts are inherently uncertain. The standard does not require all entities to default to consensus forecasts and neither auditors nor regulators should simply substitute their judgements for those of management. Rather, the auditor's role is to assess whether management's forecast is reasonable. ECLs reflect expected – not unexpected – losses. This means that they are not biased towards downturn scenarios, like stress tests are. In preparing probability-weighted estimates, the effects of more adverse possible scenarios may be offset by the effects of more benign ones. Estimates would incorporate any relevant risk management actions that an entity would undertake to manage recoveries from debtors and/or collateral in response to differing scenarios. However, an entity could not avoid recognising ECLs on the basis that it might sell financial assets in some scenarios. Future economic events may have indirect, second-order impacts as well as more obvious direct impacts. Also, different variables and scenarios may have effects that interact. These additional effects may be more difficult to model than direct impacts – the standard requires reasonable estimates based on the information available, not unattainable perfection or spurious accuracy.
What is 'reasonable and supportable' information?	**ITG members made the following comments.** **Rationale** There is no bright line marking what information is reasonable and supportable – judgement is required to make the determination. Reasonable and supportable information includes information about future events that are unlikely to occur. However, information about an event and its consequences may not be reasonable and supportable if the entity has an insufficient basis on which a reasonable estimate of its impact can be made.

Disclosures are important in explaining how estimates have been made – including whether any relevant factors have been excluded.

Issue	ITG discussion
What is 'reasonable and supportable' information? (continued)	**Uncertain future events** It is possible that an entity could have no basis to determine whether, or how, the occurrence of an event would affect credit risk or credit losses. This might not be common but may be more likely for uncertain future events for which there is no precedent – e.g. the possible exit of Scotland from the UK. However, what information is available depends on the facts and circumstances. For example, in some cases there may be: • available market prices that provide relevant information – e.g. prices for quoted bonds; or • adjustments already incorporated into an entity's pricing models and policies. **Other considerations** An entity cannot assert that there is an absence of reasonable and supportable information about a matter simply because modelling its effects appears difficult, or merely because it would involve a wider-than-usual range of possible results. Before reaching such a conclusion, an entity should have made the effort to obtain such information and found itself unable to do so, and should document its rationale. Disclosures help explain relevant information, including material forward-looking information that has been excluded from the measurement of ECLs because the entity is not able to determine a reasonable and supportable effect.

UPDATE ON BASEL COMMITTEE PROPOSALS ON ACCOUNTING FOR ECLs

A representative of the Basel Committee explained the changes that it was making in response to comments received on its proposals.

In February 2015, the Basel Committee issued proposals[12] for supervisory requirements on sound credit risk practices associated with implementing and applying ECL accounting models.

During the ITG meeting, a Basel Committee representative provided an update on these proposals, highlighting the following points.

- The Basel Committee has received strong support for issuing guidance. The proposals are being edited in response to comments received. The Basel Committee plans for the IASB and the FASB to review the final guidance to ensure that it does not conflict with their respective accounting standards.
- The final guidance will apply to internationally active banks. Guidance for other banks would be a matter for local supervisors.
- The final guidance is expected to emphasise:
  - the concepts of materiality, proportionality and compliance with the spirit of accounting standards;
  - the use of forward-looking information – e.g. the guidance will continue to state that internationally active banks should not rely solely on past-due information – and expert credit judgement;
  - the need for allowances for impairment to be adequate;
  - limitations on the use of practical expedients;
  - the symmetrical nature of the IFRS 9 stage transfer model – i.e. exposures may migrate back from lifetime ECL measurement to 12-month ECL measurement; and
  - the principles for disclosures, although the guidance will not introduce new disclosure requirements.

The Basel Committee plans to review and authorise the revised draft later this month, before forwarding it to the IASB and the FASB for their reviews. The Basel Committee expects to publish the final guidance before the end of 2015.

12. Guidance on accounting for expected credit losses, available from the Basel Committee website.

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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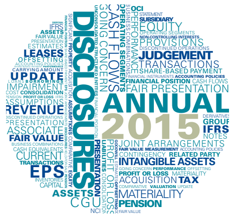

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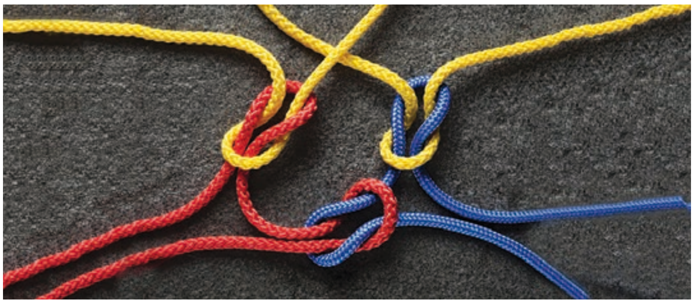

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