Summary of IFRS Exposure Draft – Financial Instruments: Expected Credit Losses

April 2014

In March 2013, the International Accounting Standards Board (IASB) issued an Exposure Draft (ED) relating to the 2^{nd} phase of the financial instruments project (i.e., amortized cost and impairment of financial instruments). Once these proposals are finalized they will be added as a chapter to IFRS 9 *Financial Instruments* and replace the current incurred loss model under IAS 39.

This document highlights the objective of the proposals, the key differences between the old and new impairment models and provides a summary with an example of the proposals.

Who Will be Impacted by These Proposals?

There is a simplified approach for trade and loan receivables and investments with low credit risk which is expected to apply to many of MNP's clients. While all MNP clients are impacted, Credit Unions will likely be affected the most.

Objectives of the Proposals

The proposals aim to address the concerns raised during the financial crisis on the current IAS 39 "incurred loss" impairment model by proving users of the financial statements with more useful information about the entity's expected credit losses. The proposals also reduce the complexity of impairment testing for financial instruments by requiring the same model for all financial instruments subject to impairment testing.

Key Differences Between IAS 39 and Proposed Impairment Models

Current IAS 39 Incurred Loss Model	Proposed IFRS 9 Expected Credit Loss Model
▪ Delays the recognition of credit losses until there is evidence of a credit loss event. ▪ Only past events and current conditions are considered when determining the amount of impairment (i.e., the effects of future credit loss events cannot be considered, even when they are expected).	▪ Expected credit losses would be recognized from initial recognition and at each subsequent reporting period, even if they have not yet been incurred. ▪ In addition to past events and current conditions, reasonable and supportable forecasts affecting collectability are also considered when determining the amount of impairment.
Different impairment models for different financial instruments subject to impairment testing.	The model will be applied to all financial instruments subject to impairment testing, including: ▪ Financial assets at amortized costs ▪ Financial asset mandatorily measured at FV through OCI (based on recent IFRS 9 amendment proposed) ▪ Trade and lease receivables ▪ Loan commitments ▪ Financial guarantee contracts

Key Questions Answered:

What are Expected Credit Losses and How are They Estimated?

- **Credit losses** = present value of the differences between contractual cash flows and cash flows expected to be received over the life of the instrument.
- **Expected credit losses** = credit losses multiplied by the probability of default occurring.

Example: A $100 credit loss is expected with a 5% probability of default occurring. Expected credit loss = $100 x 5% = $5.

- The estimate should reflect an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes (i.e., it is neither a worst-case scenario nor to estimate a best-case scenario).
- The time value of money is reflected by discounting the actual cash shortfalls expected at a rate between the risk-free rate and the effective interest rate.
- The proposal does not require an entity to make an exhaustive search for information. An entity should incorporate the best information which is available without undue cost or effort.
- Paragraph B5 – B8 contains guidance on information used to estimate expected credit losses. Possible data sources include: historical data, internal and external ratings, peer group experience, statistics. The estimation of expected credit losses requires extrapolation of projections, use of judgment, adjustments to historical data based on effects of current conditions and forecasts of future conditions, and regular review of actual vs. estimated.

How Will Expected Credit Losses be Reflected?

- From initial recognition as a provision (for financial guarantee contracts or loan commitment) or loan allowance (for all other financial assets subject to impairment testing).
- The initial carrying amount of financial assets will be fair value minus the loss allowance which would serve as a proxy for initial expectations of credit losses that are priced into the financial asset.
- The initial loan allowance/provision and subsequent changes will be recognized in profit or loss.
- The amount of expected credit losses will depend on changes in credit quality from initial recognition to show the link between expected credit losses and the pricing of the financial instrument. A distinction has been made between assets that have deteriorated in credit quality since initial recognition and those that have not since a true economic loss arises when expected credit losses significantly exceed initial expectations which were priced into the instrument.

Why Recognize Expected Credit Losses from Initial Recognition?

- It reflects that the yield on the instrument includes a return to cover expected credit losses from the time when a financial instrument is first recognised.
- If this amount was not recognised the full yield would be recognised as interest in revenue with no adjustment for credit losses that were always expected.

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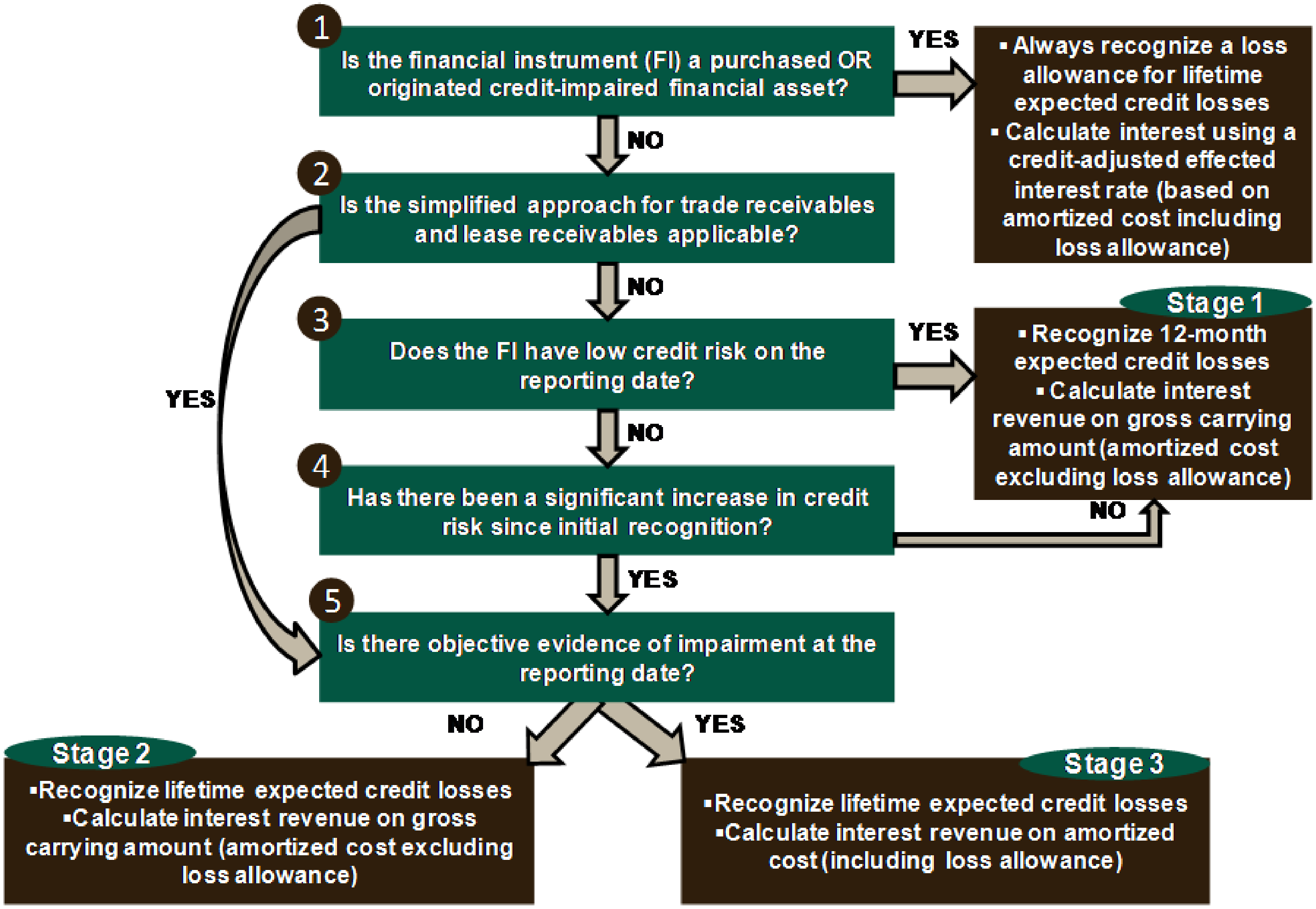
Overview of Main Proposals:

The following diagram provides an overview of the proposed process and relevant decisions:



The proposed standard contains guidance for answering each of the questions in the diagram as follows:

1. Is the Financial Instrument a Purchased OR Originated Credit-impaired Financial Asset?

- Purchased or originated credit-impaired financial assets are financial assets that have *objective evidence of impairment* on initial recognition (e.g. junk bonds).
- The proposed approach for these financial assets is as follows:
  - A lifetime expected credit loss allowance is recognized from initial recognition, with subsequent changes in profit or loss.
  - **Lifetime expected credit losses** = Expected credit losses from all possible default events over the life of the financial instrument.
  - A **credit-adjusted effective interest rate** is used to recognize interest on the amortized cost of the financial asset from initial recognition. The expected cash flows in the credit-adjusted effective interest rate calculation consider all contractual terms of the financial asset and expected credit losses.
  - The credit-adjusted effective interest rate is required to be used to discount the lifetime expected credit losses.

2. Is the Simplified Approach for Trade Receivables and Lease Receivables Applicable?

- An allowance for lifetime expected credit losses is always recognized for receivables without a significant financing component.
- An entity can elect to always recognize an allowance for lifetime expected credit losses for receivables with a significant financing component and lease receivables. The policy election has to be consistently applied to all these receivables. If no election was made, 12-month expected credit losses may be recognized based on the outcome of questions 3 and 4.

3. Does the Financial Instrument Have Low Credit Risk on the Reporting Date?

- The proposal provides an exception to the recognition of lifetime expected credit losses for financial assets with low credit risk. For these instruments 12-month expected credit losses are recognized.
- **12-month expected credit losses** = Credit losses over the life of the financial instrument that result from possible defaults in the next 12 months x the probability of default in the next 12 months.
- **Low credit risk** = when default is not imminent and any adverse economic condition or changing circumstances may lead to at most a weakened capacity of the borrower to meet its contractual cash flow obligations, (e.g. a loan with internal credit risk rating equivalent to investment grade – in Canada BBB rated or better is considered low risk).

4. Has There Been a Significant Increase in Credit Risk Since Initial Recognition?

- The entity considers the change in probability of default since initial recognition rather than the change in the amount of expected credit losses if default occurs.
- Because the probability of default decreases as the remaining life of the instrument decreases, a change in credit risk cannot be assessed simply by comparing the change in the absolute probability of default occurring over time.
  - Example: If probability of default occurring for a financial instrument with remaining life of 10 years at initial recognition is identical to the probability of default occurring in that financial instrument when its remaining life in a subsequent period is only 5 years, this may indicate an increase in credit risk because the probability of default is expected to decrease.
- Typically, information that is more forward-looking than past-due is used. However, if contractual payments are more than 30 days past due there is rebuttable presumption that credit risk has significantly increased.
- An entity shall make this assessment on an individual instrument basis. However, a collective basis may be used when the instruments have shared similar risk characteristics that are indicative of the borrowers’ ability to pay all amounts due in accordance with the contract terms.
- Para B11-B21 of the ED contains considerations for determining whether there has been a significant increase in credit risk since initial recognition. The example below lists 3 of these considerations in the Stage 2 box.

5. Is There Objective Evidence of Impairment at the Reporting Date?

- **Objective evidence of impairment** exists when one or more events that occurred have an impact on the expected future cash flows of the financial instrument. It includes observable data that came to the attention of the holder of the financial instrument about the following events:
  - Significant financial difficulty of the issuer or borrower.
  - Breach of contract (e.g. default or delinquency in interest or principal payments).
  - Lenders of the borrowers (for economic or contractual reasons relating to the borrower’s financial difficulty) having granted to the borrower concessions that they would not otherwise consider.
  - Becoming probable that the borrower will enter bankruptcy or other financial reorganization.
  - Disappearance of an active market for the financial asset because of financial difficulty.
  - Purchase of financial assets at a deep discount that reflect the incurred credit losses.
- It may not be possible to identify a single discrete event – instead, the combined effect of several events is considered.

Example:

The example illustrates the general approach for a financial instrument based on the deterioration of credit quality since initial recognition which is reflected as Stage 1 - Stage 3.

Entity A originates a loan for $1000 (FV at initial recognition) with a term of 4 years and an interest rate of 3% per annum. The loan was not a purchased or originated credit-impaired financial instrument.		
Stage 1	**Stage 2**	**Stage 3**
Deterioration of credit quality since initial recognition		
At the end of year 1, the credit quality has not increased significantly since initial recognition.	At the end of year 2, the credit quality has deteriorated significantly since initial recognition. This is evidenced by: • Significant changes in operating results (e.g. decline in revenues, decreasing asset quality). • Significant adverse changes in the economic environment. • Significant adverse changes in internal price indicators of credit risk.	At the end of year 3, there is now objective evidence of impairment. This is evidenced by: • Entity A failed to make its annual interest payment. • There is still evidence that Entity A is experiencing significant financial difficulty.
Entity A estimates that the instrument has a 1% probability of default in the next 12 months. Entity A assumes $200 will be lost if the loan defaults. The $200 is calculated as the present value of the cash shortfalls expected over the life of the instrument if the default occurs in the next 12 months.	Entity A estimates that the probability of default occurring over the remaining life of the loan is 5%. The expected credit losses from all possible default events are expected to be $500.	Entity A estimates that the probability of default occurring over the remaining life of the loan is 5%. Entity A only expects to recover the collateral at the end of year 4. The estimated present value of the collateral is $800.
Loss allowance based on 12-month expected credit losses = 200 x 1% = $2	Loss allowance based on full lifetime credit losses = $500 x 5% = 25.	Loss allowance based on full lifetime losses = 1030 – 800 = 230
Interest recognized = 3% x $1000 = $30.	Interest recognized = 3% x $1000 = $30.	Interest recognized Year 3 = 3% x $1000 = $30. Interest recognized Year 4 = 800 x 3% = $24

This table demonstrates the amounts recognized for the above loan:

End of year	Opening Gross Carrying Amount	Interest Recognized	Cash Flows (Interest and Collateral) Received	Gross Carrying Amount	Loan Allowance	Amortized Cost
1	1,000	30	30	1,000	2	998
2	1,000	30	30	1,000	25	975
3	1,000	30	-	1,030	230	800
4	1,030	24	824	230	230	0

Note: Financial assets can move in and out of the stages above depending on credit quality of the financial asset at the reporting date (e.g. an instrument in stage 3 can move back to stage 1 when all outstanding balances are paid, their future prospects are good and the economy is growing).

Other proposals:

Modifications

If financial instruments that were renegotiated or modified but did not result in derecognition, an entity shall recalculate the gross carrying amount on the basis of the renegotiated or modified contractual cash flows and recognise a modification gain or loss in profit or loss.

Write-off

The gross carrying amount of a financial asset shall be directly reduced when the entity has no reasonable expectations of recovery. A write-off constitutes a derecognition event.

Disclosure

The overall disclosure objective is to identify and explain:

- The amounts in the financial statements arising from expected credit losses.
- The effect of deteriorations and improvements in the credit quality.

Judgment is required to determine: the level of detail and aggregation provided; how much emphasis to place on each requirement; and whether to include additional information to help users evaluate the quantitative information.

Examples of disclosures required are:

- Reconciliations of gross carrying amounts and loss allowance/provisions.
- Inputs, assumptions and estimation techniques used in calculating expected credit losses and determining whether credit risk has significantly increased since initial recognition.
- The gross carrying amounts of financial assets per credit risk rating grades.
- Quantitative and qualitative analysis of significant effects on the loss allowance caused by a particular portfolio or geographical area.
- Information on modifications and write-offs, including the policy.
- Information on collateral or other credit enhancements.

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