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In depth

IFRS 9 Impairment: Revolving credit facilities and expected credit losses

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Foreword

The introduction of the expected credit loss ('ECL') impairment requirements in IFRS 9 Financial Instruments represents a significant change from the incurred loss requirements of IAS 39. With this change comes additional complexity, both in interpreting the technical requirements and in applying them. For banks, as well as some other financial institutions, the change may be as significant, if not more so, than the initial adoption of IFRS.

Many banks grant revolving credit facilities to their customers, such as credit cards and overdraft facilities. Due to their unique nature, IFRS 9 contains an exception for such products to its general principle for determining the period over which to estimate expected credit losses. The scope and application of this exception give rise to some complex issues, both conceptually and in practice.

Whilst industry thinking will almost inevitably continue to evolve, to help you navigate this complex area this publication brings together our latest thinking in key 'Frequently Asked Questions'. The complexities make clear and insightful disclosure critical, as highlighted in some of the Frequently Asked Questions. The full suite of our Frequently Asked Questions on IFRS 9 and our publication 'IFRS 9 for banks – Illustrative disclosures' can be found at inform.pwc.com.

It will be important for accountants, modellers and others involved in IFRS 9 implementation projects to consider the ECL impairment implementation as a whole, given the interdependencies between the different elements. But we hope you find this focused publication on revolving credit facilities both practical and useful. If you have any questions on the publication, or on other matters related to IFRS 9, please speak to your usual PwC contact, to the IFRS 9 lead contact in your territory listed at the end of this publication, or with either of us.

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Question:

Paragraph 5.5.20 of IFRS 9 contains an exception for certain types of financial instruments to measure ECL over the period that the entity is exposed to credit risk, even if that period extends beyond the contractual period. The exception applies to some financial instruments that include both a loan and an undrawn commitment.

This seems to indicate that, in order for the exception to apply, a facility must have both drawn and undrawn components. However, in many cases, at any point in time, a facility might only have an undrawn component, such as a credit card or overdraft facility.

Is it necessary for the financial instrument to have both drawn and undrawn components at the measurement date for the exception in IFRS 9 to apply?

Solution:

No. The rationale for the exception, as expressed in paragraph BC5.261 of IFRS 9, is to ensure that sufficient loss allowance is established for contracts where 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.

A financial instrument might have only an undrawn balance at the reporting date, but the nature of the instrument is that it might have a drawn and undrawn component over its life, with the drawn component moving between nil and the instrument's credit limit (such as credit cards and overdrafts). For these instruments, ECL should still be recognised in the same way as they would be for the undrawn portion of an instrument that has both a drawn and undrawn component at the reporting date. For example, a credit card which has been originated just before the reporting date, but is yet to be used, will require recognition of an ECL allowance.

Paragraph B5.5.39 of IFRS 9 also gives an example of a credit card as an instrument that can be withdrawn by the lender with little notice but that, in practice, exposes the lender to credit risk for a longer period. At any point in time, a portfolio of credit cards is likely to include instruments that have drawn down amounts and those that do not.

2. Does IFRS 9 paragraph 5.5.20 apply only to retail credit cards and retail overdrafts?

FAQ 45.60.1

Question:

Does paragraph 5.5.20 of IFRS 9, which that requires that expected credit losses on certain revolving credit facilities be measured over a longer period than the maximum contractual period, apply only to retail credit cards and retail overdrafts?

Solution:

No. Though often discussed in the context of retail credit cards and retail overdrafts provided to individual customers, IFRS 9 does not state that paragraph 5.5.20 only applies to these types of products. Therefore, the individual characteristics of all revolving credit facilities ('RCFs') that might fall within the scope of paragraph 5.5.20 need to be considered, including those provided to wholesale and corporate customers, to assess whether or not they fall within its scope. Where an entity such as a bank has many RCFs, it may be appropriate to group RCFs with suitably similar characteristics together when performing this assessment.

Paragraph 5.5.20 of IFRS 9 describes the financial instruments that fall within its scope, and paragraph B5.5.39 of IFRS 9 sets out three characteristics (a)-(c) that are generally associated with such financial instruments. Key considerations in assessing these general characteristics, as well as the overall principle and relevant disclosure requirements, are discussed below.

Overall principle

The 'exception' in paragraph 5.5.20 to the more general IFRS 9 requirement that the period over which ECL is measured be limited to the maximum contractual period, only applies to those financial instruments where[1]:

- The instrument has the ability to have both a loan and undrawn commitment component;
- The entity has the contractual ability to demand repayment of the loan component and to cancel the undrawn commitment component; and
- The entity's exposure to credit losses is not limited to the contractual notice period.

As a result, not all RCFs with a contractual ability to demand repayment of the loan component and to cancel the undrawn commitment component fall in the scope of paragraph 5.5.20. Judgement is required, in particular in determining which wholesale and corporate RCFs fall in the scope of this paragraph.

The December 2015 meeting of the IFRS Transition Resource Group for Impairment of Financial Instruments ('ITG') also noted that '...the exception was intended to be limited in nature and that it was introduced in order to address specific concerns raised by respondents in relation to RCFs that were managed on a collective basis'. This importance of managing collectively versus individually is further discussed within general characteristics (b) and (c) below. Therefore where it is concluded that a financial instrument is managed individually, rather than on a collective basis, it would generally be expected that the financial instrument would not fall within the scope of paragraph 5.5.20 and instead the ECL would be measured over the maximum contractual period in accordance with paragraph 5.5.19.

Paragraph B5.5.39 of IFRS 9 provides general characteristics of financial instruments that fall in the scope of paragraph 5.5.20 which are helpful in interpreting paragraph 5.5.20, in particular what is meant by 'the entity's exposure to credit losses is not limited to the contractual notice period'. However, these general characteristics are not determinative and therefore, do not all need to be met in order for paragraph 5.5.20 to apply. Where some, but not all, of the general characteristics set out in paragraph B5.5.39 are present an entity should consider the principle in paragraph 5.5.20, that is, '...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'. If the overall principle is not met, the requirement in paragraph 5.5.20 should not be applied.

The three general characteristics in B5.5.39

B5.5.39(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)

As highlighted by the December 2015 ITG, all the terms of the financial instrument should be considered. For example, if when an RCF is drawn the resulting drawn loan has a fixed maturity of 5 years and the lender does not have the contractual ability to demand repayment of the drawn exposure, this would not be consistent with the RCFs described in paragraph 5.5.20, where repayment of drawn amounts can be demanded. But if the fixed maturity were only 1 month, rather than 5 years, then judgement would be required to determine if this would prevent the instrument from falling within the scope of paragraph 5.5.20.

However, as noted above just because this general characteristic is not met does not prevent a financial instrument being within the scope of paragraph 5.5.20, if the overall principle is met. This is illustrated by the immediately revocable revolving credit facility with a fixed maturity of 5 years that was also considered by the December 2015 ITG. In this case, the ITG concluded that the facility would not seem inconsistent with the type of facility described in paragraph 5.5.20, despite the facility having a fixed maturity, because the lender has the contractual ability to cancel the entire facility including both the drawn amount and the undrawn commitment at any point[2].

B5.5.39(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

IFRS 9 BC5.255 notes 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' [emphasis added].

The key factor to consider is therefore what information the lender has available which it *could* use so as to have the practical ability to cancel the contract before a loss event occurs. This means that if in practice, as a result of how a lender manages its portfolio, it will not become aware of an increase in credit risk of a particular borrower until after it has occurred, either because relevant information to identify this cannot be obtained or as the lender chooses not to obtain such information, then that facility would be expected to meet this general characteristic. This would generally be the case for a financial instrument that is collectively managed (also refer to general characteristic (c) below). Conversely, if a lender could reasonably be expected to obtain relevant information giving them the practical ability to act earlier, then the facility would not be expected to meet this general characteristic. This would generally be the case for a financial instrument that is individually managed.

As the availability of information is the key factor, a facility would still not meet this general characteristic if a lender obtains the relevant information but then chooses not to act upon it, for example to maintain what was considered to be a valuable customer relationship. This is because the lender would have had the practical ability to withdraw the commitment before a loss event occurred and so limit its exposure to credit losses to the contractual period over which it was committed to extend credit, but chose not to.

B5.5.39(c) The financial instruments are managed on a collective basis

The term 'managed on a collective basis' is not defined within IFRS 9. However, IFRS 9 paragraph B5.5.1 states '...it may be necessary to perform the assessment of significant increases in credit risk *on a collective basis* by considering information that is indicative of significant increases in credit risk on, for example, a group or sub-group of financial instruments' [emphasis added]. Furthermore, IFRS 9 paragraph B5.5.3 notes that there are '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 until a customer breaches the contractual terms'. This reinforces the principle outlined above, that the key factor to consider is the availability of information that can be used to take credit risk management actions before it is 'too late'.

As a result, the term 'managed on a collective basis' refers to portfolios where the information used to manage the credit risk of the exposures is obtained primarily at an aggregated level.

As IFRS 9 provides no further guidance on the term 'collective', judgement will be required in assessing whether or not a financial instrument is managed on a collective basis and where in the spectrum of available information the 'dividing line' is drawn between collective and individual management. This will depend on individual facts and circumstances, in particular how a bank manages its credit risk. For some exposures, the bank may have more information than for others and so be more able to take action earlier. In particular, in practice it will likely vary with type and size of client (for example, between the biggest listed corporates and the smallest 'SME' customers). However, examples of credit risk information that might be obtained and monitored individually for a particular financial instrument, demonstrating that it is managed on an individual rather than collective basis, would include regular covenant reporting, management accounts information or updates on financial performance obtained from regular contact with the borrower as well as credit risk information about the borrower obtained from publicly available sources.

Other indicators that may be relevant in judging whether a financial instrument is managed collectively or individually include:

- Availability of public information – For example, there is more likely to be publicly available information about an individual borrower if it is a large or listed company;
- Frequency of information – For example, if information on the individual customer is regularly obtained then it is more likely the facility would be considered individually monitored;
- Nature and extent of credit officer monitoring – For example, a single customer where monitoring is the sole duty of an individual credit officer would be considered individually monitored, whereas a facility with a customer monitored by a credit officer also responsible for 999 other lending relationships would generally not be; and
- Historic practice – For example, whether for similarly managed financial instruments there is past evidence of proactive decisions being made on individual borrowers to take credit risk management action ahead of a loss event occurring.

Monitoring account utilisation at the individual RCF level, which can be performed for any RCF using the information readily available from the lender's own records, would not be a differentiating factor in assessing whether a financial instrument is managed collectively or individually.

Disclosure

Entities should make appropriate disclosure of the judgements they have made in determining the scope of paragraph 5.5.20 of IFRS 9 and applying paragraph B5.5.39, given that paragraph 35G of IFRS 7 requires an entity to explain the assumptions used to measure expected credit losses.

In addition, disclosure explaining how RCFs are managed will be relevant to the requirement in paragraph 35B of IFRS 7 to provide information about the entity's credit risk management practices and how they relate to the recognition and measurement of expected credit losses.

1 Refer to paragraph 27 of the IASB summary of the December 2015 ITG meeting.

2 Refer to paragraph 31 of the IASB summary of the December 2015 ITG meeting.

B: Significant increase in credit risk

3. Date of initial recognition of a revolving credit facility

FAQ 45.61.2

Question:

What is the date of initial recognition for the purposes of assessing significant increases in credit risk for a revolving credit facility?

Solution:

This issue was also discussed by the ITG in its April 2015 meeting. It was noted by several ITG members that determining the date of initial recognition for revolving credit card facilities is a significant operational challenge. There can be numerous changes to a credit card facility over the life of a customer relationship, including changes in card type, expiry and renewal of cards, changes in credit limits, and periodic credit reviews. The ITG acknowledged that it is very important to determine whether such an event gives rise to de-recognition under IFRS 9 and the recognition of a new financial instrument. This will require considerable judgement.

It is expected that entities might look to find some practical simplifications, such as looking to PDs or internal ratings at previous reporting dates to justify whether there has been a significant increase in credit risk.

4. *Can the date of initial recognition for determining a significant increase in credit risk be 'reset' to the date of a substantial increase in a loan commitment or credit facility?*

FAQ 45.25.1

Question:

Paragraph 5.5.9 of IFRS 9 states that, when assessing whether the credit risk on a financial instrument has increased significantly since initial recognition, an entity should compare the risk of a default at the reporting date with the risk of a default at the date of initial recognition.

If the terms of a loan commitment or credit facility are amended (for example, there is a substantial increase in the size of the facility), can the date of initial recognition for determining a significant increase in credit risk be 'reset' to the date of the substantial increase in the loan commitment or facility?

Solution:

It depends. The date of initial recognition under paragraph 3.1.1 of IFRS 9 is the date when the entity becomes party to the contractual provisions of the instrument. This is typically when a financial instrument is first recognised on the balance sheet but, as clarified by paragraph B5.5.47 of IFRS 9, in the case of a loan commitment it is the date when the entity becomes a party to an irrevocable commitment. If the terms of a financial instrument are subsequently amended, the instrument only has a new date of initial recognition if the change in terms results in de-recognition of the original financial instrument and recognition of a new financial instrument (see FAQ 44.27.1 on inform.pwc.com).

Judgement will be required to assess which modifications are sufficiently substantial to result in de-recognition in accordance with the entity's accounting policy. A substantial increase in the size of a credit facility or loan commitment could be viewed as a substantial modification and result in de-recognition, but this will depend on the specific facts and circumstances.

Of itself, a credit review, however thorough, would not be sufficient to result in de-recognition of a financial instrument and subsequent recognition of a new financial instrument. Rather, it is any changes to the terms of the loan commitment or facility that result from a credit review that are relevant.

C: Life of a revolving credit facility

5. Life of a revolving credit facility

FAQ 45.61.2

Question 1:

What is the appropriate life to calculate ECL for revolving credit facilities that are in stage 1 and stage 2?

Solution 1:

This issue was discussed by the IFRS Transition Resource Group for Impairment of Financial Instruments ('ITG') in its April 2015 meeting. The members of the ITG generally agreed that determining that the period over which an entity is exposed to credit risk and the ECL would not be mitigated by credit risk management, as compared to the contractual period, adds considerable complexity to the calculation. This might require a greater segmentation of the book, including periods of less than 12 months, if appropriate.

The ITG discussed the IFRS 9 requirement for an entity to estimate ECL over the period that the entity is exposed to credit risk and the ECL that would not be mitigated by credit risk management actions. These discussions focused on what is meant by 'period of exposure' versus 'mitigated by credit risk management actions'. An example was provided of a bank that does not perform annual credit reviews on its credit cards but assesses changes in the behaviour of the customer on a monthly basis, based on payment profiles and external credit information. It is unlikely that the bank in this example would terminate the facility until there was strong evidence to suggest that the customer was in default. The ITG members noted that there is diversity in credit risk management in this area, that risk management differs from accounting, and that significant judgement would be required for the measurement of ECL on revolving credit card facilities.

6. *Period for measuring ECL of revolving credit facilities and interaction of factors in paragraph B5.5.40 of IFRS 9*

FAQ 45.61.3

Question:

Paragraph B5.5.40 of IFRS 9 requires that, when determining the period to measure expected credit losses (ECL) for revolving credit facilities within the scope of paragraph 5.5.20 of IFRS 9, entities should consider factors such as historical information and experience about:

- The period over which the entity was exposed to credit risk on similar financial instruments;
- The length of time for related defaults to occur on similar financial instruments following a significant increase in credit risk; and
- The credit risk management actions that an entity expects to take once the credit risk on the financial instrument has increased, such as the reduction or removal of undrawn limits.

How should an entity take into account the interaction of these three factors when determining the period over which to measure ECL for revolving credit facilities within the scope of paragraph 5.5.20 of IFRS 9?

Solution:

An entity is required to consider all of the three factors listed in paragraph B5.5.40 of IFRS 9. The factor that gives rise to the shortest period is the relevant factor for determining the life of a particular facility for ECL measurement purposes. For example, some revolving credit facilities in a portfolio might not be expected to default or have credit risk management actions taken, and so paragraph B5.5.40(a) (that is, the period for which the entity is exposed to credit risk on similar instruments) is more relevant in determining their life. However, other revolving credit facilities might be expected to default, and so a shorter period would be more appropriate in accordance with the factors in paragraph B5.5.40(b) or (c). If credit risk management actions that mitigate the entity's exposure to credit risk are expected to be taken before some facilities default, paragraph B5.5.40(c) is more relevant for those facilities. However, for those facilities that are expected to default before such credit risk management actions are taken, paragraph B5.5.40 (b) is more relevant.

An entity might be able to identify specific facilities based on reasonable and supportable information for which one or more particular factors might be relevant (such as for large corporate facilities). Otherwise, an entity should appropriately stratify and segment its portfolio into sub-groups or portions of the portfolio, as recommended by the Transition Resource Group for Impairment of Financial Instruments (ITG) at its meeting in April 2015. The entity should consider the specific characteristics of the portfolio and the relevance of the various factors in paragraph B5.5.40 to segment the portfolio and ascertain how to most appropriately determine the period to measure ECL for each sub-group. For example, higher-risk exposures within the portfolio might be more likely to be subject to credit risk management action and, to the extent of these credit risk management actions, they could have a shorter life than other facilities within the portfolio. Within each homogeneous sub-group of facilities, more than one factor might be relevant. A particular factor and expected life might be expected to be relevant to a percentage of the sub-group, even if the exact composition of that portion is not known at the outset.

During its life, a revolving credit facility could transition between stages (for example, from stage 1 to stage 2, and back to stage 1 again). The transition between stages itself does not affect the life of the facility. However, a significant increase in credit risk could result in credit risk mitigation actions being taken, for example, which would be relevant to determining the life of the facility.

Segmenting a portfolio and determining the period over which to measure ECL should be based on historical data and experience, together with the implications of forward-looking information and any future changes in policies (for example, if a bank changes its credit risk management policies, so that credit risk management actions are expected to take place sooner than they would have under its historical policies). This is likely to involve significant judgement. A bank should disclose information about significant judgements that are a major source of estimation uncertainty in the financial statements, in accordance with paragraph 125 of IAS 1.

7. How do credit reviews and 'credit risk management actions', such as the removal of undrawn limits, affect measurement of ECL for revolving credit facilities?

FAQ 45.61.4

Paragraph 5.5.20 of IFRS 9 contains an exception for certain types of financial instrument to measure expected credit losses (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. See FAQ A2 above for guidance on the financial instruments that are within the scope of this exception.

Paragraph B5.5.40 of IFRS 9 sets out the factors that an entity should consider when determining the period over which to measure ECL (referred to below as the 'life'). FAQ C6 above provides further guidance on the interaction between these three factors. This FAQ considers specifically how credit card reviews and 'credit risk mitigation actions' in paragraph B5.5.40(c) of IFRS 9 affect the measurement of ECL.

Question 1: Can the period to the next credit review be used to determine the life of a revolving credit facility within the scope of paragraph 5.5.20 of IFRS 9?

A bank undertakes an annual credit review of every facility in its credit card portfolio. As part of its normal business practice, the bank expects to fully terminate the limits of 9% of the accounts as a result of the next credit review. Can the period to the next credit card review be used as the life of the whole portfolio for determining the period to measure ECL for revolving credit facilities within the scope of paragraph 5.5.20 of IFRS 9?

Solution:

No. As noted in FAQ C6, paragraph B5.5.40 of IFRS 9 sets out three factors to consider when determining the life of a revolving credit facility within the scope of paragraph 5.5.20.

The first factor is the period over which the entity was exposed to credit risk on similar instruments (para B5.5.40 (a) of IFRS 9). Performing a credit review, however substantial, would not itself be indicative of de-recognition of a facility. If the entity continues to grant credit in accordance with the contractual terms of the facility, the entity continues to be exposed to credit risk.

However, one of the other factors to take into consideration is the credit risk management actions that an entity expects to take once the credit risk on the financial instrument has increased, such as the reduction or removal of undrawn limits. [IFRS 9 para B5.5.40(c)].

Accordingly, it is the expected credit risk management actions resulting from a credit review that are relevant for determining the life of a facility, not merely the performance of a credit review. This is consistent with the observations of the Transition Resource Group for Impairment of Financial Instruments (ITG) at its meeting in December 2015 and the IASB's webcast, 'IFRS 9 Impairment: The expected life of revolving facilities'. In this case, only the 9% of the portfolio for which the limit is expected to be terminated should have a life that is shortened to reflect the timing of the expected credit risk management actions arising from the next annual credit review. For the remainder of the portfolio, the other factors in paragraph B5.5.40 or expected credit risk management actions at a later date are relevant.

If an entity is able to identify which particular facilities will be subjected to the credit risk management action using reasonable and supportable information, it should shorten their specific lives. Otherwise, it would be appropriate to shorten the life of a proportion of the portfolio or a specific segment (for example, by stratifying and segmenting the portfolio), to reflect the expected credit risk mitigation actions.

Different credit risk management practices will impact the expected life of a portfolio. For example, if Banks A, B and C all perform regular credit reviews, but:

- Bank A expects to take no further credit risk mitigation actions, the credit review itself does not affect or shorten the expected life;
- Bank B expects to fully terminate some facilities, the expected life for only those facilities is shortened; and
- Bank C expects to fully terminate all facilities with an increase in credit risk, the expected life is shortened to the next review date for all facilities expected to increase in credit risk.

Similarly, using the same credit rating scale, if Bank X fully terminates undrawn limits for facilities with a credit rating of 8 or worse, but Bank Y has a policy of fully terminating facilities with a credit rating of 7 or worse, Bank X would be expected to have longer exposures to those riskier instruments than Bank Y, all other things being equal. Under paragraph B5.5.40(c) of IFRS 9, Bank X would therefore be expected to measure ECL over a longer life for those exposures than Bank Y.

Question 2: What effect does a reduction rather than a termination of an undrawn facility limit have on the period over which ECL is measured?

If the credit risk-mitigating action expected to be undertaken is to reduce an undrawn facility limit (as opposed to removing it altogether) under paragraph B5.5.40(c) of IFRS 9, is the life of the entire facility limited to the period up to the date when the reduction is expected to occur?

Solution:

No. A reduction in the undrawn facility only shortens the life for the amount expected to be reduced. For example, if an undrawn limit was expected to be cut from CU1,000 to CU600, only CU400 of the facility (that is, the amount of the reduction) would have its life limited to the expected date of the reduction. The life of the remaining facility amount of CU600 would not be limited by this particular credit risk management action. This is consistent with the principle in paragraph B5.5.31 of IFRS 9, which requires an entity's estimate of ECL on a loan commitment to be consistent with its expectations of draw-downs on that loan commitment.

Question 3: What impact does the reinstatement of a previously curtailed credit limit have on the period over which ECL is measured?

A customer had an undrawn limit of CU1,000. As a result of the customer's credit risk increasing, the undrawn limit was curtailed to CU600. If the customer's credit risk were subsequently to reduce, the original credit limit of CU1,000 would be reinstated.

In the context of paragraph B5.5.40(c) of IFRS 9, does an entity need to consider only those credit risk management actions which serve to mitigate credit risk, as opposed to all credit risk management actions (that is, including actions that do not mitigate credit risk, such as the reinstatement of previously curtailed credit limits)?

Solution:

Yes. The December 2015 meeting of the IFRS Transition Resource Group for Impairment of Financial Instruments ('ITG') noted that, if an entity has taken credit risk mitigation actions in respect of that exposure (such as the curtailment of the credit limit), it would not be appropriate to take into consideration the possibility that the exposure might subsequently cure, resulting in a reinstatement of the previously curtailed credit limit when determining the maximum exposure period.

8. How should the period over which ECL is measured be determined for wholesale and corporate revolving credit facilities?

FAQ 45.60.2

Question:

Revolving credit facilities are provided by an entity to corporate and wholesale customers (that is, not to individual or 'retail' customers), and they have no fixed term. The facilities can be cancelled at the discretion of the lender at any time, with one day's notice. The terms and conditions also state that the facility will be subject to, at a minimum, an annual credit review, at which point this cancellation right could be exercised.

How should the period over which ECL is measured be determined for these wholesale and corporate revolving credit facilities?

Solution:

IFRS 9 does not refer to 'wholesale', 'corporate' or 'retail', so the requirements of IFRS 9 should be applied consistently to revolving credit facilities irrespective of the type of customer. Therefore, an entity should first determine whether a revolving credit facility is within the scope of:

- Paragraph 5.5.19 of IFRS 9, where the maximum period to consider when measuring ECL is the maximum contractual period (including extension options) over which the entity is exposed to credit risk; or
- Paragraph 5.5.20 of IFRS 9, where ECL is measured over the period that the entity is exposed to credit risk and would not be mitigated by credit risk management actions.

This judgement is discussed in detail in FAQ A2 ('Does the requirement in paragraph 5.5.20 of IFRS 9 apply only to retail credit cards and retail overdrafts?').

Having established which of these paragraphs is applicable to a revolving credit facility, the entity should then apply the appropriate guidance:

- If the revolving credit facility is within the scope of paragraph 5.5.19 of IFRS 9, the ECL should be measured over the contractual notice period of one day. Even if, in practice, the one-day contractual cancellation right is often only exercised following an annual credit review, this would not extend the period of measurement beyond the one-day contractual notice period. As noted at the April 2015 meeting of the IFRS Transition Resource Group for Impairment of Financial Instruments ('ITG')[1], a lender could choose to continue extending credit, without having the contractual obligation to do so, and consequently there might be a disconnect between the accounting and credit risk management views. The one-day period would also apply regardless of whether there had been a significant increase in credit risk.
- If the revolving credit facility is within the scope of paragraph 5.5.20 of IFRS 9, the guidance set out in FAQ C6 and FAQ C7 will apply to a wholesale or corporate revolving credit facility just as it would to a retail credit card or any other revolving credit facility.

1 Refer to paragraph 38 of the IASB summary of the April 2015 ITG meeting.

D: Measurement of ECL

9. How to measure ECL on revolving credit facilities

FAQ 45.61.1

Bank A provides co-branded credit cards to customers in conjunction with a local department store. The credit cards have a one-day notice period, after which bank A has the contractual right to cancel the credit card (both the drawn and undrawn components). However, bank A does not enforce its contractual right to cancel the credit cards in the normal day-to-day management of the instruments and only cancels facilities when it becomes aware of an increase in credit risk and starts to monitor customers on an individual basis. Bank A therefore does not consider that the contractual right to cancel the credit cards limits its exposure to credit losses to the contractual notice period. For credit risk management purposes, bank A considers that there is only one set of contractual cash flows from customers to assess, and it does not distinguish between the drawn and undrawn balances at the reporting date. The portfolio is therefore managed, and ECL are measured, on a facility level.

At the reporting date, the outstanding balance on the credit card portfolio is C60,000 and the available undrawn facility is C40,000. Bank A determines the expected life of the portfolio by estimating the period over which it expects to be exposed to credit risk on the facilities at the reporting date, taking into account:

a. The period over which it was exposed to credit risk on this portfolio or on a similar portfolio of credit cards;

b. The length of time for related defaults to occur on this portfolio or on similar financial instruments; and

c. Past events that led to credit risk management actions because of an increase in credit risk on similar financial instruments, such as the reduction or removal of undrawn limits.

Bank A determines that the expected life of the credit card portfolio is 30 months. At the reporting date, it assesses the change in the credit risk on the portfolio since initial recognition and determines that the credit risk on a portion of the credit card facilities representing 25% of the portfolio has increased significantly since initial recognition. The outstanding balance on these credit facilities for which lifetime ECL should be recognised is C20,000, and the available undrawn facility is C10,000.

When measuring the ECL, bank A considers its expectations about future draw-downs over the expected life of the portfolio (that is, 30 months) and estimates what it expects the outstanding balance (that is, exposure at default) on the portfolio would be if customers were to default. By using its credit risk models, bank A determines that the exposure at default on the credit card facilities for which lifetime ECL should be recognised is C25,000 (that is, the drawn balance of C20,000 plus further draw-downs of C5,000 from the available undrawn commitment). The exposure at default of the credit card facilities for which 12-month ECL are recognised is C45,000 (that is, the outstanding balance of C40,000 and an additional draw-down of C5,000 from the undrawn commitment over the next 12 months).

The exposure at default and expected life determined by bank A are used to measure the lifetime ECL and 12-month ECL on its credit card portfolio. Bank A measures ECL on a facility level and therefore cannot separately identify the ECL on the undrawn commitment component from those on the loan component. It recognises ECL for the undrawn commitment, together with the loss allowance for the loan component in the statement of financial position. To the extent that the combined ECL exceed the gross carrying amount of the financial asset, the ECL should be presented as a provision.

When estimating ECL on revolving credit facilities, expected life can be greater than contractual life.

10. Measurement of ECL for revolving credit facilities with 'shadow' credit limits

FAQ 45.60.3

Question:

A bank holds a portfolio of revolving credit facilities (such as credit cards, or current accounts with overdraft facilities) within the scope of paragraph 5.5.20 of IFRS 9. Accordingly, the bank measures expected credit losses (ECL) over a period that might extend beyond the maximum contractual period. Under the contractual terms of the facilities, each customer is given a written credit limit. In addition, the bank holds higher internal 'shadow' credit limits for each customer. In practice, the bank has historically allowed its customers to draw-down amounts that exceed their contractual limit, up to the amount of the 'shadow' limits. The bank has determined that this 'shadow' limit is not enforceable by the customer. At the reporting date, should the bank measure ECL based on the expected future draw-downs up to the amount of the 'shadow' limits?

Solution:

No. Paragraph B5.5.30 of IFRS 9 clarifies that, for undrawn loan commitments, a credit loss is measured based on the contractual cash flows that are due to the entity if the loan is drawn down. This excludes expected future draw-downs that exceed the contractual credit limit as notified to the customer at the reporting date. This is because, at the reporting date, the bank is not obligated to provide credit up to its 'shadow' limit.

This was discussed at the meeting of the Transition Resource Group for Impairment of Financial Instruments (ITG) in September 2015 and confirmed by the IASB at its meeting in October 2015. The ITG and IASB observed that, because, in practice, the tenor and amount of revolving credit facilities were inextricably linked, there could be a disconnect between the accounting and credit risk management view.

If, at the reporting date, the customer has drawn down an amount in excess of the contractual limit, ECL is measured based on the full amount of the draw-down, because the customer has an obligation to repay it.

The amount of the contractual credit limit is the amount that is enforceable by law in accordance with the agreement between the bank and its customer, which will depend on the specific facts and circumstances. Whilst this is clear in some cases (such as the example above), in other cases it might be less clear cut (for example, where there is no written credit limit between the bank and its customer). If the bank approves each draw-down as it is requested and has the practical ability to refuse credit at the point of each draw-down, the bank has no contractual commitment to provide credit for expected future drawings. However, if the customer is able to enforce a draw-down up to a higher amount, this higher amount would be the contractual credit limit.

11. *What discount rate should be used when measuring ECL for credit cards and other similar products?*

FAQ 45.55.1

Question:

The contractual interest rate on credit cards and other similar products can be significant, and the discount rate used can have a significant impact on the expected credit loss (ECL) impairment provision recognised under IFRS 9.

What discount rate should be used when measuring ECL for credit cards and other similar products?

Solution:

The definition of credit loss in Appendix A to IFRS 9 states that cash flows should be discounted at the original effective interest rate (EIR), other than for purchased or credit-impaired financial assets.

In practice, determining the original EIR for credit cards and other similar products can be complex and judgemental, particularly since the contractual interest rate can vary significantly from period to period for the same credit card customer. This can occur if, for example, the contractual terms specify that customers (sometimes referred to as 'transactors') will incur 0% interest if amounts spent on the card are paid off within a specified period such as one month, but customers (sometimes referred to as 'revolvers') will incur a much higher rate of interest, say 20%, if the amount is not paid off within the specified period.

In assessing whether an entity's approach to calculating the original EIR under IFRS 9 is appropriate, relevant factors to consider include:

- **Internal consistency** – The IFRS 9 definition of ECL states that the relevant cash flows should be discounted using the original effective interest rate. Hence, the same EIR should be used for discounting ECL as is used in measuring interest income, in calculating modification gains/losses under paragraph 5.4.3 of IFRS 9, and in any other calculation where the use of original EIR is required.
- **Segmentation** – As discussed in the December 2015 meeting of the IFRS Transition Resource Group for Impairment of Financial Instruments ('ITG') in the context of determining the period over which to measure ECL for revolving credit facilities[1], portfolios should be appropriately segmented, or grouped on the basis of shared characteristics, when calculating ECL. The segmentation of portfolios should ensure that ECL is measured in a way that is unbiased and does not combine different facilities that do not have suitably similar characteristics. The importance of appropriate segmentation applies equally to EIR as it does to other aspects of the ECL calculation. An entity should therefore assess whether, on the basis of reasonable and supportable information that is available without undue cost or effort, the level of disaggregation and segmentation applied (including differentiation between 'transactors' and 'revolvers') is appropriate.
- **Monitoring segmentation** – An individual customer facility might change from being a transactor incurring 0% interest to a revolver incurring 20% interest, and vice versa, over the life of the facility. If this is the case, and if the credit card is considered to be a floating rate instrument, segmentation should therefore be considered on an ongoing basis and might need to change from one period to another.
- **Stage 2** – Where a facility has had a significant increase in credit risk at the reporting date (so is in 'stage 2') the ECL must be modelled on the basis that the customer fails to pay off their future balance in some instances (para 5.5.18 of IFRS 9). It follows that, in those instances, there will be an unpaid balance at default on which to incur a credit loss. Since the customer will, at that stage, be incurring 20% interest, use of a 0% EIR is not appropriate for stage 2 facilities.

Additional considerations might arise when an entity transitions from IAS 39 to IFRS 9. The definition of EIR in IFRS 9 is identical to the definition in IAS 39; so, from a technical perspective, no change is required. However, there might nonetheless be a need to make changes from an implementation perspective. One reason is that EIR calculations might have validly been performed at very aggregated levels under IAS 39, where appropriate interest income recognition was the only material consideration. However, such a level of aggregation might no longer be appropriate under IFRS 9, where the original EIR will also be used to discount ECL on specific facilities over potentially long time periods.

1 Refer to paragraph 44 of the IASB summary of the December 2015 ITG meeting.

E: Presentation

12. Presentation of ECL for undrawn loan commitments

FAQ 45.82.1

Question:

Should an entity present the loss allowance on undrawn loan commitments as a negative asset or separate liability?

Solution:

Paragraph B8E of IFRS 7 clarifies that loss allowance arising on an undrawn loan commitment is recognised as a provision within liabilities.

However, in some cases (for example, credit card facilities), a financial instrument includes both a loan (that is, financial asset) component and an undrawn commitment (that is, loan commitment) component and the entity cannot separately identify the expected credit losses on the loan commitment component from those on the financial asset component. In such circumstances, the expected credit losses on the loan commitment should be recognised together with the loss allowance for the financial asset. To the extent that the combined expected credit losses exceed the gross carrying amount of the financial asset, the expected credit losses should be recognised as a provision.

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