

International Financial Reporting Standards

Financial Instruments: Expected Credit Losses

IAASB – March 2015

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Benefits of the expected loss model

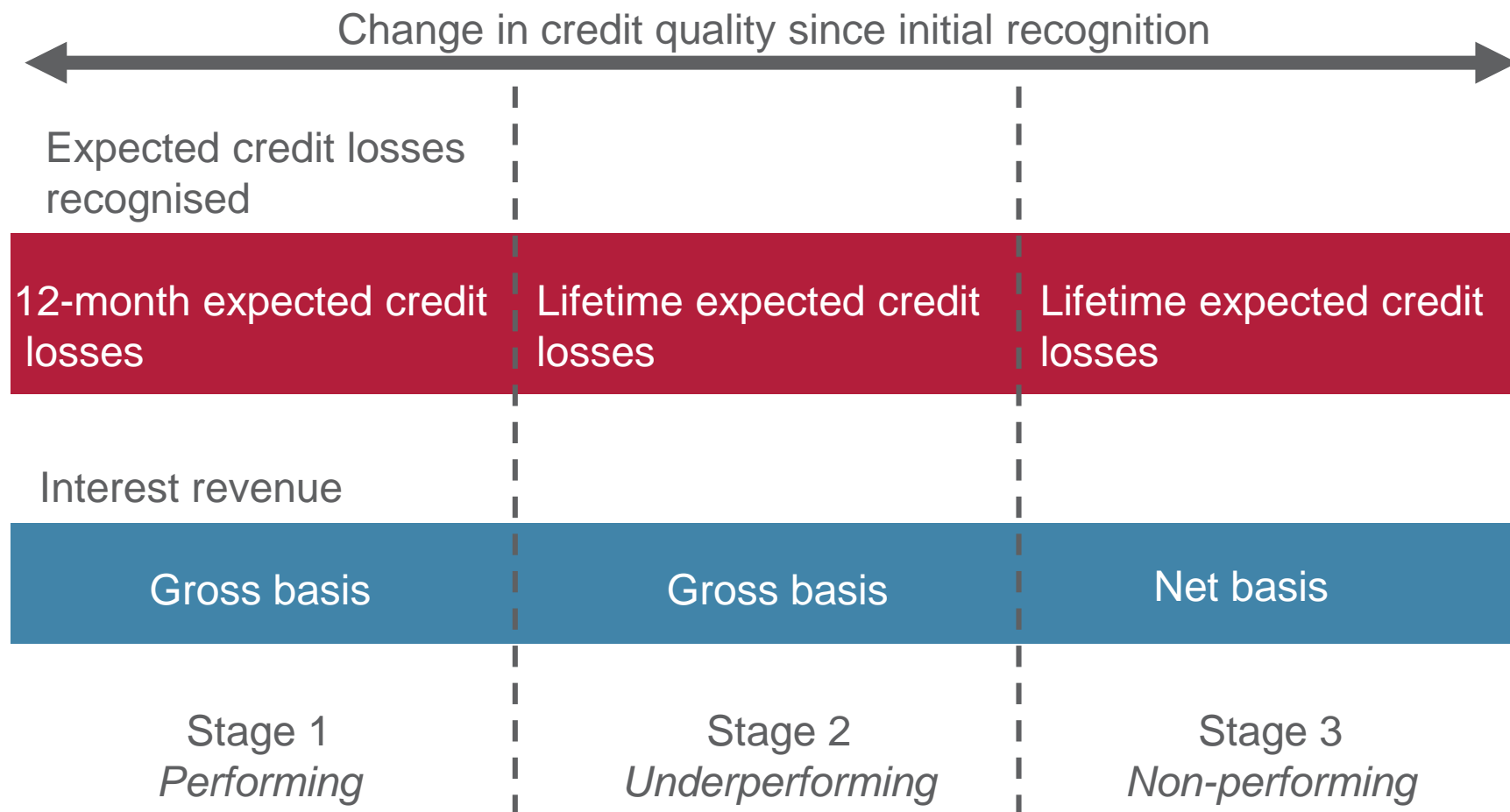
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Forward-looking model that is responsive to changes in credit risk and responds to the calls of the G20 and others

- Broader range of information required to be considered
 - Ensures more timely recognition of ECL
 - Elimination of IAS 39 threshold to recognise ECL
- Builds on existing systems to balance costs and benefits
 - Approximates 2009 ED in more operational manner
- Single model reduces complexity of multiple approaches
- Shows assets that have significantly increased in credit risk
- Robust disclosures to illustrate estimates and credit risk

Overview of general model

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Expected credit losses (ECL)

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When to recognise 12-month expected credit losses?

- Performing assets, ie
 - No significant increase in credit risk; or
 - Low credit risk (for example ‘investment grade’)

In all other cases, ie underperforming or non performing assets, lifetime expected credit losses will be recognised.

Assessment of deterioration in credit quality

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- Change in credit risk over the life of the instrument (ie risk of a default occurring)
 - Not changes in expected losses
 - Compared to credit risk at initial recognition
- Maturity matters
- Does not require a mechanical assessment
- Use information that is available without undue cost or effort
- Can be done on an individual or collective basis

Expected credit losses are updated at each reporting date for new information and changes in expectations even if deterioration is not significant

Assessment of deterioration in credit quality

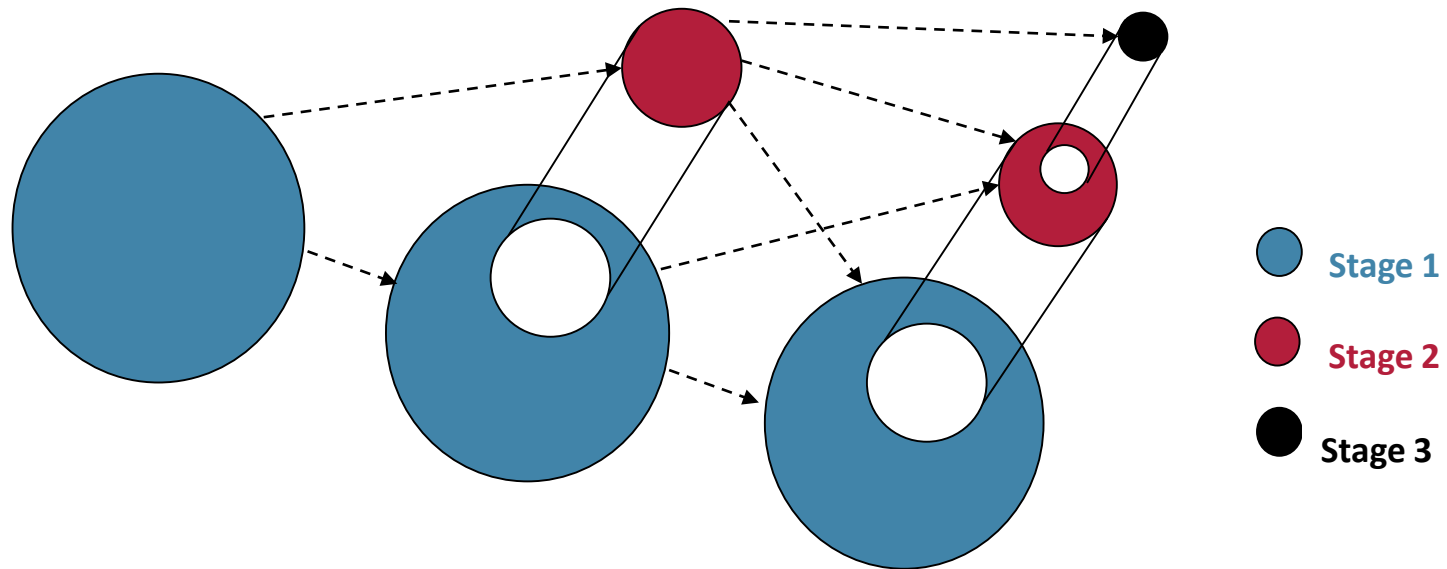
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As information emerges over time – entity is able to better distinguish credit quality of loans

Portfolio of home loans originated in a country.

Information emerges that a region in the country is experiencing tough economic conditions.

More information emerges and the entity is able to identify the particular loans that are in default or will imminently default.



- Operational simplification for high quality financial instruments
- Choice to assume that a financial instrument considered low credit risk would remain in stage 1
- Therefore, no need to assess whether changes in credit risk have been significant
- Still need to update expected credit losses for changes in expectations even if in stage 1

Measuring expected credit losses

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- Information used to measure expected credit losses and assess changes in credit:
 - Available without undue cost or effort
 - Historical, current and reasonable and supportable forecasts
 - Historical information must be updated
 - Delinquency information may be used

Particular measurement methods are not prescribed; nor must probability of default be explicitly included as an input

Measuring expected credit losses

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What information could be considered in measuring forward-looking ECL?

- Borrower specific:
 - changes in operating results of borrower
 - technological advances that affect future operations
 - changes in collateral supporting obligation
- Macro-economic:
 - house price indexes, GDP, household debt ratios
- Internal default rates and probabilities of default
- External pricing:
 - Credit rating agency information

Information needs to be reasonable and supportable



- Assessment of a deterioration in credit risk
 - individual or collective basis
 - shared credit risk characteristics
 - defining default
 - incorporating forward looking macro economic information
 - identifying low credit risk assets
- Estimating expected credit losses
 - identifying the appropriate models to estimate a probability weighted outcome which incorporates forward looking information

- The standard provides guidance on the factors to be considered in making these assessments
- Entities will have to provide appropriate disclosures outlining the inputs, assumptions and techniques used to in estimating expected credit losses

Auditors will need to develop ways of testing management judgements in this area

Quantitative

Reconciliation of allowance accounts showing key drivers for change

Explanation of gross carrying amounts showing key drivers for change

Gross carrying amount per *credit risk grade or delinquency*

Write-offs, recoveries, modifications

Qualitative

Inputs, assumptions and techniques used to estimate expected credit losses (and changes in techniques)

Inputs, assumptions and techniques used to determine 'significant increase in credit risk' and 'default'

Inputs, assumptions and techniques used to determine 'credit impaired'

Write off policies, modification policies, collateral

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