World Council

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World Council's Summary of International Accounts Standards Board Exposure Draft *Financial Instruments: Expected Credit Losses*

On March 7, 2013 the International Accounts Standards Board (IASB) issued for public comment an exposure draft entitled *Financial Instruments: Expected Credit Losses IFRS 9*. The exposure draft's proposed changes to International Financial Reporting Standards (IFRS), if adopted, would require credit unions and other entities subject to IFRS to recognize and measure credit loss allowances based on an expected credit loss model. Recognition of expected future credit losses on loans and other financial instruments without significant credit quality deterioration would be limited to the credit losses forecast for the next 12 months; more significantly deteriorated loans and financial instruments would be written down to reflect lifetime expected credit losses.

This proposed IFRS 9 expected loss approach would be a significant change from the current IFRS standard, IAS 39, which uses an incurred loss model. This proposal would therefore be likely to require credit unions and other entities to increase their allowance for loan and lease losses (ALLL), and related ALLL expenses, at least during the transition to IFRS 9. The consultative document does not propose an effective date for these changes if they are adopted; however, IFRS 9 is currently scheduled to become effective on January 1, 2015.

The IASB's stated reason for moving to an expected loss model is that the IAS 39 incurred loss model's delayed recognition of credit losses "was identified during the financial crisis as a weakness in existing accounting standards." The IASB proposal would apply to loans and debt securities, as well as bonds, trade receivables, lease receivables, and binding loan commitments.

IFRS 9 uses a "three bucket approach" where, under the proposal:

1. Bucket 1 ("stage 1") would be for loans and other instrument without significant credit problems, and expected credit losses would be calculated on a portfolio-wide (or "bucket-wide") basis and limited to losses forecast within the next 12 months.

2. Bucket 2 ("stage 2") would be for loans and other instruments with a history of credit problems that have not yet had "objective evidence of a credit loss event;" items in bucket 2 would have lifetime expected losses recognized on a portfolio-wide basis.

3. Bucket 3 ("stage 3") would be for large problems loans and instruments that "have objective evidence of impairment on the reporting date." Bucket 3 would include large or seriously credit impaired loans and other financial instruments, and each loan or instrument would be reviewed individually to determine its likely lifetime credit losses (i.e. no portfolio/bucket-wide analyses).

Under the proposal, credit unions and other entities subject to IFRS would be required to consider past events in order to project future credit losses, including "historical credit loss events for similar financial instruments, current conditions and reasonable and supportable forecasts that affect the expected collectability of cash flows on financial instruments. As a result, an entity would consider quantitative and qualitative factors that are specific to the borrower, including the entity's current evaluation of the borrower's creditworthiness. An entity would also consider general economic conditions and an evaluation of both the current point in, and the forecast direction of, the economic cycle."

For uncollectable items, the early recognition of credit losses will include incurred losses and expected future losses.

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This proposal differs from the Financial Action Standards Board's (FASB) approach under U.S. generally accepted accounting principles (U.S. GAAP), but is likely to result in similar losses for financial assets that have deteriorated significantly since their initial recognition. FASB has proposed an alternative model that deals with a single measurement objective for recognition. According to the IASB:

> In July 2012, the FASB decided to revisit its previous tentative decisions on that joint [IASB-FASB] model and has since decided to develop an expected credit loss model in which no distinction has been made between those financial instruments that have deteriorated in credit quality since initial recognition and those that have not. Under the FASB's proposed Current Expected Credit Loss ('CECL' model), expected credit losses are always recognised at what is described as 'lifetime expected credit losses' in the IASB's proposals. This is in contrast to the IASB's proposal to measure expected credit losses for some financial instruments at an amount equal to 12-month expected credit losses.

IASB will accept public comments until July 5, 2013.

Please contact VP and Chief Counsel Michael Edwards at medwards@woccu.org or Research and Communication Specialist Peter Pieh at ppieh@woccu.org for more information about this IASB proposal.