EXPECTED CREDIT LOSS MODEL

‘‘Credit Impairment under IFRS 9’’

IFRS 9

IASBs new accounting standard
on financial instruments
is effective since Jan 2018

IFRS 9

It contains three areas of accounting for financial instruments:

1) Classification and Measurement
2) Impairment
3) Hedge Accounting

IFRS 9, replaces IAS 39
for recognizing credit losses in banks accounting boks.

Under IFRS 9,

the approach for measuring credit risk and accounting for it

has changed fundamentally from **INCURRED LOSS** model

to **EXPECTED CREDIT LOSS** model.

Previous to IFRS 9,

an allowance for credit losses used to be estimated

based on *historical data*,

such as, delinquencies in repayments,

impairment in collateral

or other adverse conditions of the borrower.

As a result of the criticism from 2008 financial crisis;

IFRS 9 introduces
'a forward looking model'
called

EXPECTED CREDIT LOSS

The banks have to ESTIMATE the *expected credit losses*
BEFORE *credit events* have taken place.

The **E**xpected **C**redit **L**osses (**ECL**)
are estimated from;

using REASONABLE and SUPPORTABLE information
from past, present and future

Expected Credit Loss

Example: A borrower takes out a **$100,000** loan for a condo. *Assume:*

Probability of Default (PD) : 5%

Loss Given Default (LGD) : 50%

Exposure at Default (E@D) : $100,000 (*at the beginning)*

Expected Loss(1): EL = PD x LGD x E@D

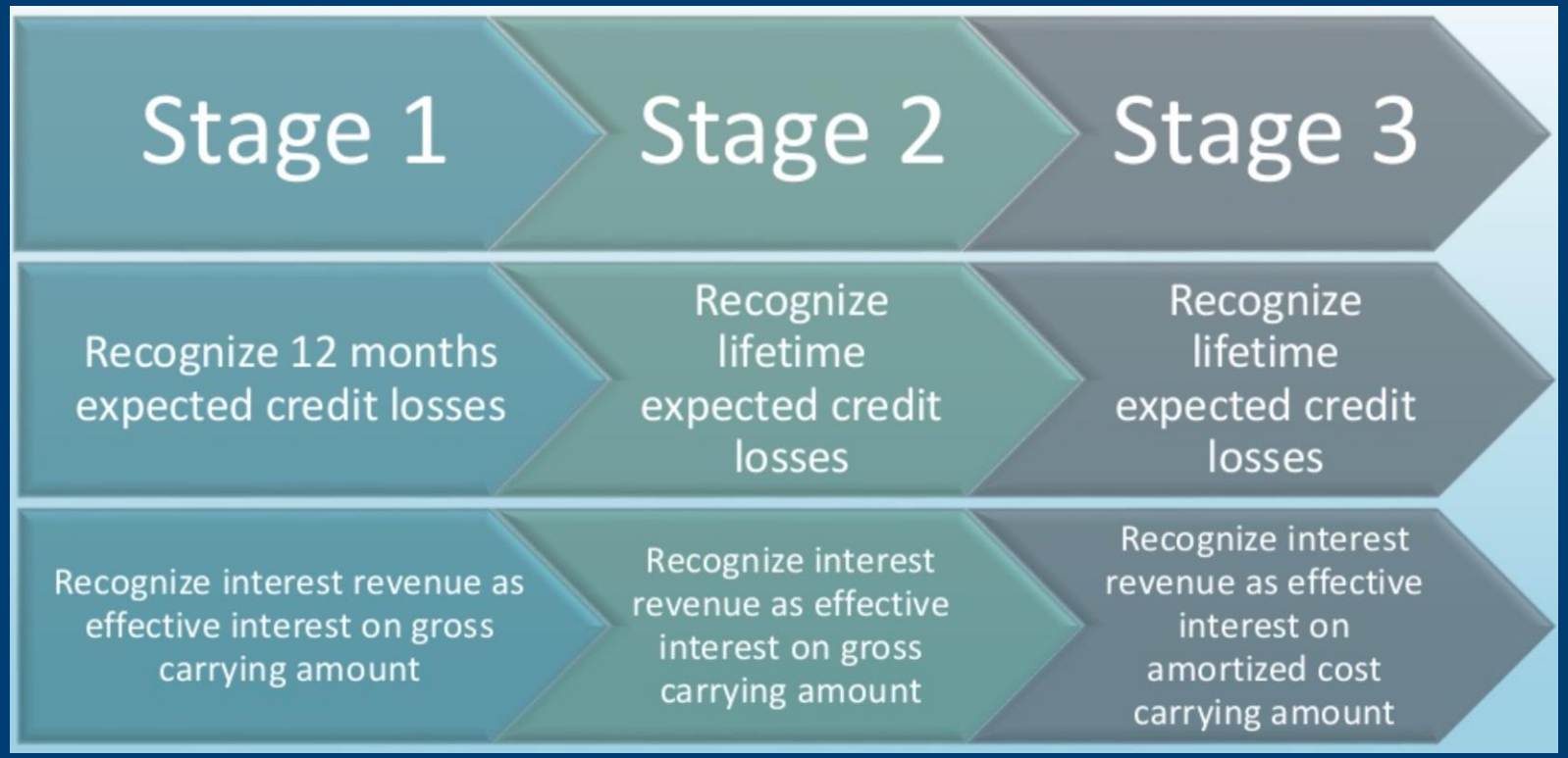
= 0.05 x 0.50 x 100,000 = $2,500

After a few installment payments, the borrower defaults at **$80,000**. The bank forecloses on the condo and is able to sell it for **$60,000**. So, the net loss would be **$20,000** and the LGD is **20%** (=$20,000/$80,000).

Expected Credit Loss

IFRS 9

“ The **ECL** model contains a ‘THREE STAGE’ approach that is based on the change in credit quality of financial instruments. ”



Expected Credit Loss

IFRS 9

Stage 1

Recognize 12 months expected credit losses

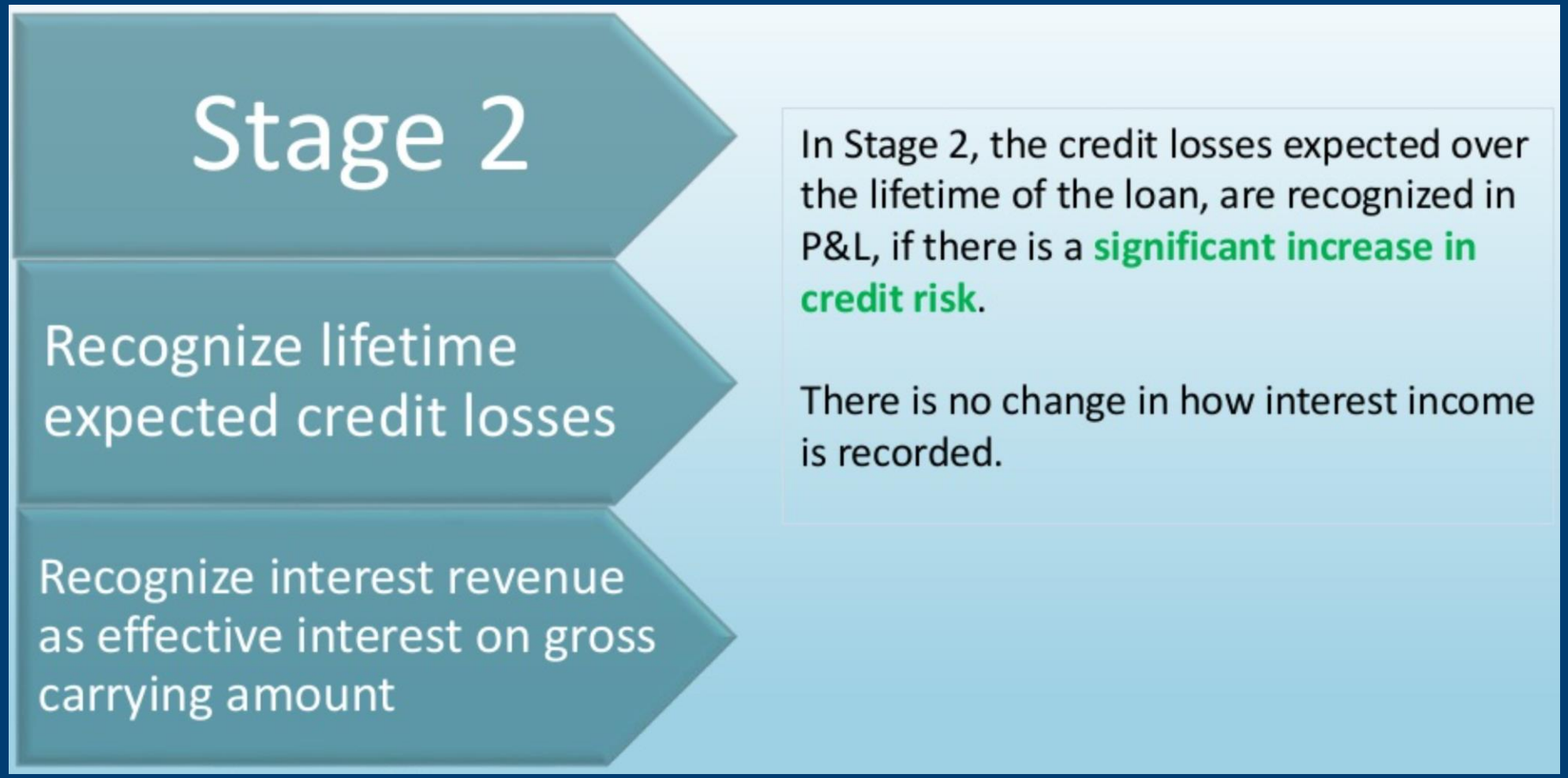
Recognize interest revenue as effective interest on gross carrying amount

In Stage 1, at the initial recording of the loan, the credit losses expected as a probability in the next 12 months (at reporting date) are recognized in P&L.

Interest income during this time is recognized at effective interest rate applied to the gross carrying amount of the loan.

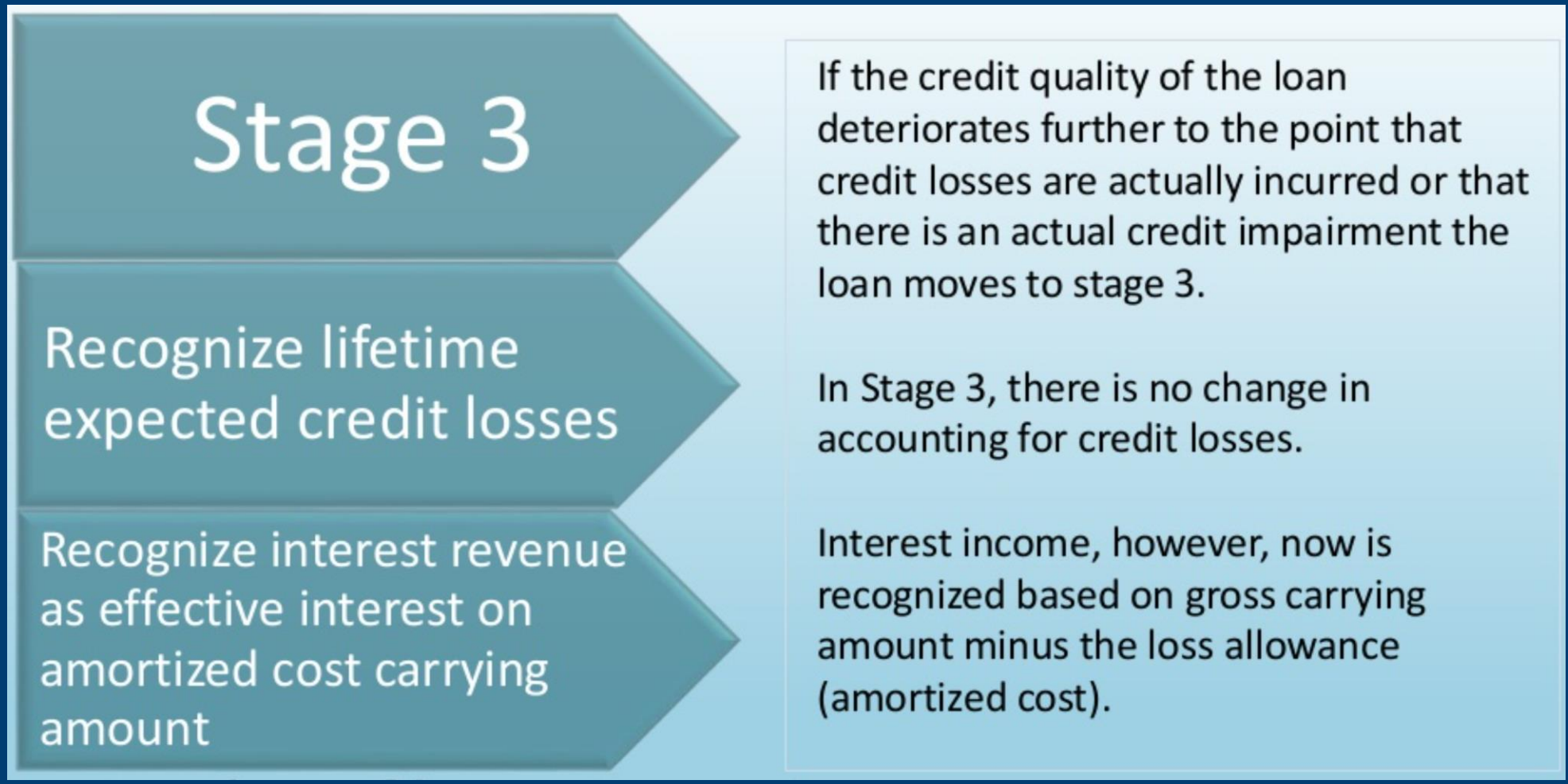
Expected Credit Loss

IFRS 9



Expected Credit Loss

IFRS 9



Example: **TONG, T.L. (2015) 'A Review of the ECL Model of IFRS 9'**

An entity generates a loan recevieable **$1,000,000** in **2021**.
The loan is fully repayable at the end of **2030**.
Effective interest rate: **6%** per year ➔ each year

*Assume that the loan deafults in 5 years and the actual loss is **$250,000***

01.01.2021

Dr Loan receivable – amortised cost asset	1,000,000	
Cr Cash		1,000,000
Dr Impairment loss in profit or loss (1% x 250,000)	2,500	
Cr Loss allowance in financial position		2,500

Example: **TONG, T.L. (2015) 'A Review of the ECL Model of IFRS 9'**

An entity generates a loan recevieable **$1,000,000** in **2021**.
The loan is fully repayable at the end of **2030**.

*Suppose the probability of default increases slightly to **1.5%***

	31.12.2021	
Dr Impairment loss in profit or loss (3,750 – 2,500)	1,250	
Cr Loss allowance in financial position		1,250

Example: **TONG, T.L. (2015) 'A Review of the ECL Model of IFRS 9'**

An entity generates a loan recevieable **$1,000,000** in **2021**.
The loan is fully repayable at the end of **2030**.

Significant deterioration of the credit quality
*but there is **NO objective evidence** of an impairment loss.*

31.12.2022

Dr Impairment loss in profit or loss (100,000 – 3,750)	96,250	
Cr Loss allowance in financial position		96,250

Example: **TONG, T.L. (2015) 'A Review of the ECL Model of IFRS 9'**

An entity generates a loan recevieable **$1,000,000** in **2021**. The loan is fully repayable at the end of **2030**.

*Suppose **till 2024**, the credit quality of the loan continues to deteriorate but there is still NO objective of impairment.*

***Aggregated for* 2023 & 2024**

Dr Impairment loss in profit or loss	100,000	
Cr Loss allowance in financial position		100,000

Example: **TONG, T.L. (2015) 'A Review of the ECL Model of IFRS 9'**

An entity generates a loan recevieable **$1,000,000** in **2021**.
The loan is fully repayable at the end of **2030**.

*Assume that the loan DEFAULTS at the **end of 2025***
*and the actual impairment loss is 'estimated' at **$250,000**.*

31.12.2025

Dr Impairment loss in profit or loss	50,000	
Cr Loss allowance in profit or loss		50,000

Example: **TONG, T.L. (2015) 'A Review of the ECL Model of IFRS 9'**

An entity generates a loan recevieable **$1,000,000** in 2021.
The loan is fully repayable at the end of 2030.

31.12.2025

THE **NET CARRYING AMOUNT** OF THE LOAN: **$750,000**

Example: **TONG, T.L. (2015) 'A Review of the ECL Model of IFRS 9'**

An entity generates a loan recevieable **$1,000,000** in **2021**. The loan is fully repayable at the end of **2030**.

*If the same transaction has been executed for **IAS 39**, then the impairment loss would've been recognized on **31.12.2025***

31.12.2025 *(IAS 39)*

Dr Impairment loss in profit or loss	250,000	
Cr Loss allowance in profit or loss		250,000

Example: **TONG, T.L. (2015) 'A Review of the ECL Model of IFRS 9'**

An entity generates a loan recevieable **$1,000,000** in **2021**.
The loan is fully repayable at the end of **2030**.
*If at the beginning of **2026** the **LOAN is SOLD** to a third party for **$740,000** then journal entry would be as following:*

01.01.2026

Dr Cash	740,000	
Dr Loss allowance in financial position – derecognised	250,000	
Dr Loss on disposal in profit or loss	10,000	
Cr Gross loan receivable – derecognised		1,000,000

Example: TONG, T.L. (2015) 'A Review of the ECL Model of IFRS 9'

Loan Receivable

(1)	$1,000,000	$1,000,000	(7)

Cash

(7)	$740,000	$1,000,000	(1)

Impairment Loss

(2)	$2,500
(3)	$1,250
(4)	$96,250
(5)	$100,000
(6)	$50,000

Loss Allowance

(7)	$250,000	$2,500	(2)
		$1,250	(3)
		$96,250	(4)
		$100,000	(5)
		$50,000	(6)

Transactions:

01.01.2021: (1), (2)
31.12.2021: (3)
31.12.2022: (4)
31.12.2024: (5)
31.12.2025: (6)
01.01.2026: (7)

Loss on Disposal

(7)	$10,000		

THANKS
FOR LISTENING