CREDIT RISK AND ACCOUNTING FOR EXPECTED CREDIT LOSSES GUIDELINE

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PREAMBLE

The Basel Committee on Banking Supervision (BCBS) issued Guidance on Credit Risk and Accounting for Expected Credit Losses on December 18, 2015[1].

The content in in this guideline is the same as the Basel Guidance with slight modifications to reflect language or requirements specific to the Central Bank of Barbados (Bank). These modifications do not change the BCBS requirements and are highlighted below:

1. References to "the Committee" in the Basel guidance have been changed to "the Bank" in that these are the Bank's expectations.
2. Principles 9-11 of the Basel Guidance specify Basel guidance to supervisors. As such, they have been excluded from this guideline.
3. References to "the applicable accounting framework" have been changed to IFRS as all licensees are required to use IFRS.
4. For the purposes of clarity and guidance, definitions of "model", "default" and "forbearance" were inserted.

INTRODUCTION

The Central Bank of Barbados (Bank), in furtherance of its responsibility for the regulation and supervision of licensees under the Financial Institutions Act, Cap. 324A and the International Financial Services Act, Cap. 325, has developed this guideline to provide guidance to licensees on their implementation and ongoing application of IFRS 9 Financial Instruments (IFRS 9) which requires the measurement of impairment loss allowances to be based on an expected credit loss ('ECL') accounting model rather than on an incurred loss accounting model.

This paper provides licensees with supervisory guidance on how the ECL accounting model should interact with a licensee's overall credit risk practices and regulatory framework, but does not endeavour to set out regulatory capital requirements on expected loss provisioning under the Basel capital framework.

Supervisors have a natural interest in promoting the use of sound and prudent credit risk practices by licensees. Experience indicates that a significant cause of bank failures is poor credit quality and deficient credit risk assessment and measurement practices. Failure to identify and recognise increases in credit risk in a timely manner can aggravate and prolong the problem. Inadequate credit risk policies and procedures may lead to delayed recognition

[1] (Basel Committee on Banking Supervision, 2015) available at https://www.bis.org/bcbs/publ/d350.pdf

and measurement of increases in credit risk, which affects capital adequacy and hampers the proper assessment and control of credit risk exposure. The licensee's risk management function's involvement in the assessment and measurement of accounting ECL is essential to ensuring adequate allowances in accordance with IFRS 9.

Historically, the incurred-loss model served as the basis for accounting recognition and measurement of credit losses and was implemented with significant differences from jurisdiction to jurisdiction, and among banks within the same jurisdiction, due to the development of national, regional and entity-specific practices. In the transition to an ECL framework, the Bank emphasises the importance of a high-quality, robust and consistent implementation of the IFRS 9 – ECL accounting framework.

The move to ECL accounting frameworks by accounting standard setters is an important step forward in resolving the weakness identified during the financial crisis that credit loss recognition was too little, too late. The development of ECL accounting frameworks is also consistent with the April 2009 call by the G20 Leaders for accounting standard setters to "strengthen accounting recognition of loan loss provisions by incorporating a broader range of credit information"[2].

SCOPE

This guideline applies to all entities that are licensed under the Financial Institutions Act, Cap. 324A and the International Financial Services Act, Cap. 325 that engage in business activities that give rise to credit risk. The focus of this guideline is on lending exposures – that is, loans, loan commitments and financial guarantee contracts to which an ECL framework applies. Notwithstanding the focus of this guideline, the Bank expects that a licensee will estimate ECL for all exposures as applicable under IFRS, inclusive of intragroup credit exposures and credit exposures resulting from deposits with other financial institutions.

APPLICATION AND OBJECTIVE OF THE GUIDELINE

Principles 17 and 18 of the Core Principles for Effective Banking Supervision (Basel Core Principles)[3] emphasise that licensees must have an adequate credit risk management process, including prudent policies and processes to identify, measure, evaluate, monitor, report and control or mitigate credit risk on a timely basis, and covering the full credit life cycle (credit underwriting, credit evaluation and the ongoing management of the licensee's portfolios). Additionally, adequate policies and processes must be in place for the timely identification and management of problem assets and the maintenance of adequate provisions and reserves in accordance with IFRS 9.

[2] Available at www.g20.org
[3] Available at www.bis.org/publ/bcbs230.pdf

While the implementation of the IFRS 9 – ECL accounting framework may require an investment in both resources and system developments/upgrades, standard setters have given firms a considerable time period to transition to the updated accounting requirements. On that basis, the Bank has significantly heightened supervisory expectations that licensees will have a high-quality implementation of the IFRS 9 – ECL accounting framework.

Building on the Basel guidance, these guidelines aim at ensuring sound credit risk management practices for licensees, associated with the implementation and ongoing application of the IFRS 9 – ECL accounting framework.

The Discipline of Credit Risk Assessment and Measurement

The Bank expects a disciplined, high-quality approach to the assessment and measurement of ECL under IFRS 9. The recommendations herein should be read holistically with the understanding that the examples provided are not all-inclusive and that a checklist approach to applying this guidance is not intended. For example, the guidance does not set out principles and expectations targeted at specific categories of loans such as corporate, retail and project finance. The Bank understands that credit risk management practices and information available to licensees will vary to a certain extent depending on the type of lending exposure. In this regard, certain aspects of the guidance may be more applicable to the individual credit assessment of a large corporate borrower while other aspects may be more relevant to collective assessments of a particular group of retail customers. The principles and the expectations within the guidance should be read in such a context.

Application of the Principles of Proportionality, Materiality and Symmetry

Licensees should comply with these guidelines in a manner that is appropriate to their size and internal organisation and the nature, scope and complexity of their activities and portfolios, and, more generally, all other relevant facts and circumstances of the licensee (and the group (if any) to which it belongs). The use of properly designed proportionate approaches should not jeopardise the high-quality implementation of the IFRS 9 – ECL accounting framework.

Licensees should also give due consideration to the application of the principle of materiality. However, this should not result in individual exposures or portfolios being considered immaterial if, cumulatively, these represent a material exposure to the licensee. In addition, materiality should not be assessed only on the basis of the potential impact on the profit or loss statement at the reporting date. For instance, large portfolio(s) of of high-quality credit exposures should be considered material.

When, because of considerations relating to proportionality or materiality, a licensee chooses to adopt an approach to ECL estimation that would generally be regarded as an approximation measures, it is important that such approximation methods are designed and implemented so as to avoid bias.

This guideline emphasises the timely recognition of allowances, so that the recognition of credit deterioration is not delayed. Nevertheless, the Bank recognises that the IFRS 9 – ECL accounting framework is symmetrical in the way that subsequent changes (both deteriorations and reversals of those deteriorations) in the credit risk profile of a debtor should be considered in the measurement of the allowances.

Consideration of Reasonable and Supportable Information

Licensees should consider a wide range of information when applying the IFRS 9 – ECL accounting framework. Information considered should be relevant to the assessment of credit risk and measurement of ECL of the particular lending exposure being assessed, and should include information about past events, current conditions and forecasts of future economic conditions. Information which is ultimately included in the assessment of credit risk and measurement of ECL should also be reasonable and supportable. Licensees should use their experienced credit judgement in determining the range of relevant information that should be considered and in determining whether information is considered to be reasonable and supportable. Reasonable and supportable information should be based on relevant facts and sound judgement.[4]

Consideration of Forward-Looking Information

In order to ensure a timely recognition of ECL, licensees should consider forward-looking information, including macroeconomic factors. When considering forward-looking information, licensees should apply sound judgement consistent with generally accepted methods for economic analysis and forecasting, and supported by a sufficient set of data. The extent to which forward-looking information, including macroeconomic factors, has already been integrated into existing methodologies will differ by licensee.

The Bank does not view the unbiased consideration of forward-looking information as speculative and expects management to be able to apply its experienced credit judgement in the consideration of future scenarios and take into account the potential consequence of events occurring or not occurring, and the resulting impact on the measurement of ECL. Appropriate oversight and an effective internal control system should help to ensure that bias is not introduced in the ECL assessment and measurement process.

As noted above all information considered should be relevant to the assessment and measurement of credit risk and be reasonable and supportable. Licensees should be able to demonstrate how they have considered such information in the ECL assessment and measurement process. Information should not be excluded from that process simply because an event has a low likelihood of occurring or the effect of that event on the credit risk or the amount of expected credit losses is uncertain. The Bank acknowledges that, in certain

[4] See principle 6 for further guidance on the use of experienced credit judgement in the consideration of relevant, reasonable and supportable information.

circumstances, information relevant to the assessment and measurement of credit risk may not be reasonable and supportable and should therefore be excluded from the ECL assessment and measurement process. However, in the Bank's view, these circumstances would be exceptional in nature, and the Bank expects licensees to provide a clearly documented, robust justification.

PRINCIPLES ON CREDIT RISK MANAGEMENT PRACTICES AND ACCOUNTING FOR EXPECTED CREDIT LOSSES

The fundamental concepts below provide supervisory guidance on how licensees should utilise common elements of the credit risk management process to allow for high quality and robust assessments and measurements of ECL. These concepts also promote consistency in the assessment and measurement of credit risk, development of accounting estimates and assessments of capital adequacy.

Principle 1 — Board and Senior Management Responsibilities

The board and senior management are responsible for ensuring that the licensee has appropriate credit risk management practices, including an effective internal control system, to consistently determine adequate allowances in accordance with the licensee's stated policies and procedures, the accounting framework and relevant supervisory guidance.

1.1 The licensee's board is responsible for approving and regularly reviewing the credit risk management strategy and the main policies and processes for identifying, measuring, evaluating, monitoring, reporting and mitigating credit risk consistent with the approved risk appetite set by the board. In addition, to limit the risk that lending exposures pose to depositors and, more generally, financial stability, a board should require that senior management adopt and adhere to sound underwriting practices.

1.2 To fulfil these responsibilities, the board should instruct senior management to:

a. Develop and maintain appropriate processes, which should be systematic and consistently applied, to determine appropriate allowances in accordance with IFRS 9;

b. Report periodically the results of the credit risk assessment and measurement processes, including estimates of its ECL allowances;

c. Establish, implement and, as necessary, update suitable policies and procedures to communicate the credit risk assessment and measurement process internally to all relevant staff; and

d. Senior management should be responsible for implementing the credit risk strategy approved by the board and developing the aforementioned policies and processes.

1.3 An effective internal control system for credit risk assessment and measurement is essential to enabling senior management to carry out its duties. An effective internal control system should include:

a. Measures to comply with applicable laws, regulations, internal policies and procedures;

b. Measures to provide oversight of the integrity of information used and reasonably ensure that the allowances reflected in the licensee's financial statements and reports submitted to the Bank are prepared in accordance with IFRS 9 and relevant supervisory requirements; and

c. Well-defined credit risk assessment and measurement processes that are independent from (while taking appropriate account of) the lending function, which contain:

i. an effective credit risk rating system that is consistently applied, accurately grades differentiating by credit risk characteristics, identifies changes in credit risk on a timely basis, and prompts appropriate action;

ii. an effective process to ensure that all relevant and reasonable and supportable information, including forward-looking information, is appropriately considered in assessing credit risk and measuring ECL. This includes maintaining appropriate reports, details of reviews performed, and identification and descriptions of the roles and responsibilities of staff involved;

iii. an assessment policy that ensures ECL measurement occurs at the individual lending exposure level and also, when necessary to appropriately measure ECL in accordance with IFRS 9, at the collective portfolio level by grouping exposures based on identified shared credit risk characteristics;[5]

iv. an effective model validation process to ensure that the credit risk assessment and measurement models are able to generate accurate, consistent and unbiased predictive estimates, on an ongoing basis. This includes establishing policies and procedures which set out the

[5] See Principle 3 on grouping of lending exposures on the basis of shared credit risk characteristics and Principle 4 on the adequacy of the allowance regardless of the nature of the assessment.

accountability and reporting structure of the model validation process, internal rules for assessing and approving changes to the models, and reporting of the outcome of the model validation;[6]

v. clear formal communication and coordination among a licensee's credit risk staff, financial reporting staff, senior management, the board and others who are involved in the credit risk assessment and ECL measurement process. This should be evidenced by written policies and procedures, management reports and minutes of committees; and

d. an internal audit function that independently evaluates the effectiveness of the licensee's credit risk assessment and measurement systems and processes, including the credit risk rating system.

Principle 2 — Sound ECL Methodologies

Licensees should adopt, document and adhere to policies which include sound methodologies, procedures and controls for assessing and measuring credit risk on all lending exposures. The measurement of allowances should build upon those methodologies and result in the appropriate and timely recognition of ECL in accordance with the accounting framework.

2.1 The credit risk assessment and measurement process should provide the relevant information for senior management to make its experienced judgements about the credit risk of lending exposures, and the related estimation of ECL.

2.2 The Bank expects that licensees should leverage and integrate common processes, systems, tools and data that are used within the licensee to determine if, when, and on what terms, credit should be granted; monitor credit risk; and measure allowances for both accounting and capital adequacy purposes.

2.3 The licensee's allowance methodologies should clearly document the definitions of key terms related to the assessment and measurement of ECL (such as loss and migration rates, loss events and default). Where different terms, information or assumptions are used across functional areas (such as accounting, capital adequacy and credit risk management), the underlying rationale for these differences should be documented and approved by senior management. Information and assumptions used for ECL estimates should be reviewed and updated as required by IFRS 9. Moreover, the rationale for changes in assumptions that affect the measurement of ECL should be well documented.

[6] See Principle 5 on the policies and procedures to appropriately validate internal credit risk assessment and measurement models.

2.4 The Bank expects that licensees should have in place adequate processes and systems to appropriately identify, measure, evaluate, monitor, report and mitigate the level of credit risk. During the transition to IFRS 9, existing processes and systems should be evaluated and, if necessary, modified to collect and analyse relevant information affecting the assessment and measurement of ECL.

2.5 Licensees should adopt and adhere to written policies and procedures detailing the credit risk systems and controls used in their credit risk methodologies, and the separate roles and responsibilities of the licensee's board and senior management.

2.6 Sound methodologies for assessing credit risk and measuring the level of allowances (subject to exposure type, for example retail or wholesale) should, in particular:

a. include a robust process that is designed to equip the licensee with the ability to identify the level, nature and drivers of credit risk upon initial recognition of the lending exposure to ensure that subsequent changes in credit risk can be identified and quantified;

b. include criteria to duly consider the impact of forward-looking information, including macroeconomic factors.[7] Whether the evaluation of credit risk is conducted on a collective or individual basis, a licensee should be able to demonstrate that this consideration has occurred so that the recognition of ECL is not delayed. Such criteria should result in the identification of factors that affect repayment, whether related to borrower incentives, willingness or ability to perform on the contractual obligations, or lending exposure terms and conditions. Economic factors considered (such as unemployment rates or occupancy rates) should be relevant to the assessment and, depending on the circumstances, this may be at the international, national, regional or local level;

c. include, for collectively evaluated exposures, a description of the basis for creating groups of portfolios of exposures with shared credit risk characteristics;[8]

d. identify and document the ECL assessment and measurement methods (such as a loss rate method, probability of default (PD), loss-given-default (LGD) method, or another method) to be applied to each exposure or portfolio;

e. document the reasons why the selected method is appropriate, especially if different ECL measurement methods are applied to different portfolios and types of individual exposures. Licensees should be able to explain to the Bank the rationale for any changes in measurement approach (for example, a move from a loss rate method to a PD, LGD method) and the quantitative impacts of such changes;

[7] See Principle 6 for guidance on developing estimates that incorporate forward-looking information.
[8] See Principle 3 for guidance on grouping lending exposures on the basis of shared credit risk characteristics.

f. document:

   i. the inputs, data and assumptions used in the allowance estimation process, such as historical loss rates, PD, LGD estimates and economic forecasts;

   ii. how the life of an exposure or portfolio is determined (including how expected prepayments and defaults have been considered);

   iii. the time period over which historical loss experience is evaluated; and

   iv. any adjustments necessary for the estimation of ECL in accordance with IFRS 9. For example, if current and forecasted economic conditions are different from those that existed during the historical estimation period being used, adjustments that are directionally consistent with those differences should be made. In addition, a licensee may have experienced little to no actual losses in the historical period analysed; however, current or forward-looking conditions can differ from conditions during the historical period, and the impact of these changes on ECL should be assessed and measured.

g. include a process for evaluating the appropriateness of significant inputs and assumptions in the ECL measurement method chosen. The basis for inputs and assumptions used in the process of the estimation of allowances should generally be consistent from period to period. Where the inputs and assumptions or the basis for these change, the rationale should be documented;

h. identify the situations that would generally lead to changes in ECL measurement methods, inputs or assumptions from period to period (for example, a licensees may state that a loan that had been previously evaluated on a collective basis using a PD, LGD method may be removed and evaluated individually using the discounted cash flow method upon receipt of new, borrower-specific information such as the loss of employment);

i. consider the relevant internal and external factors that may affect ECL estimates, such as the underwriting standards applied to a lending exposure at origination and changes in industry, geographical, economic and political factors;

j. address how ECL estimates are determined (for example historical loss rates or migration analysis as a starting point, adjusted for information on current and expected conditions). A licensee should have an unbiased view of the uncertainty and risks in its lending activities when estimating ECL;

k. identify what factors are considered when establishing appropriate historical time periods over which to evaluate historical loss experience. A licensee should maintain sufficient historical loss data to provide a meaningful analysis of its credit loss experience for use as a starting point when estimating the level of allowances on a collective or individual basis;

l. determine the extent to which the value of collateral and other credit risk mitigants affects ECL;

m. outline the licensee's policies and procedures on write-offs and recoveries;

n. require that analyses, estimates, reviews and other tasks/processes that are inputs to or outputs from the credit risk assessment and measurement process are performed by competent and well-trained staff and validated by staff who are independent of the licensee's lending activities. These inputs to and outputs from these functions should be well documented, and the documentation should include clear explanations supporting the analyses, estimates and reviews;

o. document the methods used to validate models for ECL measurement (for example backtests);[9]

p. ensure that ECL estimates appropriately incorporate forward-looking information, including macroeconomic factors, that has not already been factored into allowances measured on an individual exposure basis. This may require management to use its experienced credit judgement to consider broad trends in the entire lending portfolio, changes in the licensee's business model, macroeconomic factors, etc.; and

q. require a process to assess the overall appropriateness of allowances in accordance with the relevant accounting framework.

2.7 A licensee's credit risk identification process should ensure that factors that impact changes in credit risk and estimates of ECL are properly identified on a regular basis. In addition, consideration of credit risk inherent in new products and activities should be a key part of the credit risk identification process and the assessment and measurement of ECL.

[9] See Principle 5 on model validation.

2.8 Senior management should consider relevant facts and circumstances, including forward-looking information, that are likely to cause ECL to differ from historical experience and that may affect credit risk and the full collectability of cash flows.

2.9 With respect to factors related to the character, capacity and capital of borrowers, the terms of lending exposures, and the values of assets pledged as collateral together with other credit risk mitigants that may affect the full collectability of cash flows, a licensees should (depending on the type of exposure) consider:

a. its lending policies and procedures, including its underwriting standards and lending terms, that were in effect upon initial recognition of the borrower's lending exposure, and whether the lending exposure was originated as an exception to this policy. A licensee's lending policy should include details of its underwriting standards, and guidelines and procedures that drive the licensee's lending approval process;

b. a borrower's sources of recurring income available to meet the scheduled payments;

c. a borrower's ability to generate a sufficient cash flow stream over the term of the financial instrument;

d. the borrower's overall leverage level and expectations of changes to leverage;

e. unencumbered assets the borrower may pledge as collateral in the market or bilaterally in order to raise funds and expectations of changes to the value of those assets;

f. reasonably possible one-off events and recurring behaviour that may affect the borrower's ability to meet contractual obligations; and

g. timely evaluations of collateral value and consideration of factors that may impact the future value of collateral (bearing in mind that collateral values directly affect estimates of LGD).

2.10 Where they have the potential to affect the licensee's ability to recover amounts due, licensees should consider factors relating to the licensee's business model and current and forecasted macroeconomic conditions, including but not limited to:

a. competition and legal and regulatory requirements;

b. trends in the licensee's overall volume of credit;

c. the overall credit risk profile of the licensee's lending exposures and expectations of changes thereto;

d. credit concentrations to borrowers or by product type, segment or geographical market;

e. expectations of collection, write-off and recovery practices;

f. the quality of the licensee's credit risk review system and the degree of oversight by the licensee's senior management and board;

g. other factors that may impact ECL including, but not limited to, expectations of changes in unemployment rates, gross domestic product, benchmark interest rates, inflation, liquidity conditions, or technology; and

h. the incentives or willingness of borrowers to meet their obligations.

2.11 Robust credit risk methodologies should consider different potential scenarios and should not rely purely on subjective, biased or overly optimistic considerations. Licensees should develop and document their processes to generate relevant scenarios to be used in the estimation of ECL. In particular:

a. licensees should demonstrate and document how ECL estimates would alter with changes in scenarios, including changes to relevant external conditions that may impact ECL estimates or components of the ECL calculation (such as PD and LGD parameters);

b. licensees should have a documented process for determining the time horizon of the scenarios and, if relevant, how ECL is estimated for exposures whose lives exceed the period covered by the economic forecast(s) used;

c. scenarios may be internally developed or vendor-defined. For internally developed scenarios, licensees should have a variety of experts, such as risk experts, economists, business managers and senior management, assisting in the selection of scenarios that are relevant to the licensees' credit risk exposure profile. For vendor-defined scenarios, licensees should ensure that the external provider tailors the scenarios to reflect the licensees' business and credit risk exposure profile, as licensees remain responsible for those scenarios;

d. backtesting should be performed to ensure that the most relevant economic factors that affect collectability and credit risk are being considered and incorporated into ECL estimates; and

e. where market indicators (such as credit default swaps ('CDS') spreads) are available, senior management may consider them to be a valid benchmark against which to check the consistency of its own judgements.

2.12 While a licensee does not need to identify or model every possible scenario through scenario simulations, it should consider all reasonable and supportable information that is relevant to the product, borrower, business model or economic and regulatory environment when developing estimates of ECL. Forward-looking information, including economic forecasts and related credit risk factors used for ECL estimates, should be consistent with inputs to other relevant estimates within the financial statements, budgets, strategic and capital plans, and other information used in managing and reporting within a licensee.

2.13 Senior management should be able to demonstrate that it understands and appropriately considers inherent risks when pricing lending exposures. Post-initial recognition increases in credit risk requires a licensee to reassess ECL and re-measure the amount of allowance that should be recognised in accordance with IFRS 9. Licensees should take particular care of the following fact patterns, which are potentially indicative of inadequate estimates of ECL:

a. the granting of credit to borrowers based on fragile income streams (that could become non-recurrent upon a downturn) or with no documentation or limited verification of borrower income sources;

b. high debt service requirements relative to the borrower's net available expected cash flows;

c. flexible repayment schedules, including payment vacations, interest-only payments and negative amortisation features;

d. for real estate and other asset based financing, lending of amounts equal to or exceeding the value of the financed property or otherwise failing to provide an adequate margin of collateral protection;

e. undue increases in renegotiations/modifications of lending exposures due to financial difficulties faced by the borrower or other reasons (such as competitive pressures faced by licensees);

f. circumvention of the classification and rating requirements, including rescheduling, refinancing or reclassification of lending exposures;

g. undue increases in the volume of credit, especially in relation to the increase in the volume of credit by other lenders in the same market; and

h. increasing volume and severity of past-due, low-quality and impaired credit.

2.14 Licensees' accounting policies should address, and its allowance methodology should include, criteria for (a) renegotiations/modifications of lending exposures due to financial difficulties or for other reasons and (b) the treatment of purchased or originated credit-impaired lending exposures as defined under IFRS 9:

a. Licensees should take into account the following criteria regarding renegotiations/modifications of lending exposures:

    i. The allowance methodology should enable licensees to perform a robust assessment and measurement of ECL such that the allowance level continues to reflect the collectability of the substance of the renegotiated/modified exposure, irrespective of whether or not the original asset is derecognised under IFRS 9;

    ii. Renegotiations/modifications should not automatically lead to the conclusion that there has been an immediate decrease in the credit risk (or reversal of a previously assessed increase in credit risk) of the exposure. Any decrease in the reported allowance level due to improved credit risk should be supported by strong evidence. Customers should demonstrate consistently satisfactory payment performance over a reasonable period of time before credit risk would be considered to have decreased;

    iii. Subsequent to a restructuring or modification, a licensees may be able to demonstrate that it has increased its likelihood of receiving full payment of outstanding principal and/or interest; however, repayment performance in the form of interest payments alone may not be indicative of whether the collection of loan principal is reasonably assured; and

    iv. The methodologies should also call upon the lending staff to promptly notify the licensee's accounting function when exposures are renegotiated or modified to ensure appropriate accounting for the change. For more complex renegotiations and modifications, regular communication between the lending staff and the accounting function should take place.

b. The methodology should enable appropriate identification and accounting for purchased or originated credit-impaired lending. The cash flow estimates for these lending exposures should be reviewed each reporting period and updated as necessary. Such updates should be properly supported and documented, and approved by senior management.

Principle 3 – Credit Risk Rating Process and Grouping

A licensee should have a credit risk rating process in place to appropriately group lending exposures on the basis of shared credit risk characteristics.

Credit Risk Rating Process

3.1 As part of its credit risk assessment process, the Bank expects that licensees will have in place comprehensive procedures and information systems to monitor the quality of their lending exposures. These include an effective credit risk rating process that captures the varying level, nature and drivers of credit risk that may manifest themselves over time, in order to reasonably ensure that all lending exposures are properly monitored and that ECL allowances are appropriately measured.

3.2 The credit risk rating process should include an independent review function. While front-line lending staff may have initial responsibility for assigning credit risk grades and ongoing responsibility for updating the credit grade to which an exposure is assigned, this should be subject to the review of an independent review function.

3.3 The credit risk grade a licensee assigns upon initial recognition of a lending exposure may be based on a number of criteria, including product type, terms and conditions, collateral type and amount, borrower characteristics and geography or a combination thereof, depending on the licensee's level of sophistication. Existing credit risk grades assigned may subsequently change on either a portfolio or an individual basis due to other relevant factors such as, but not limited to, changes in industry outlook, business growth rates, consumer sentiment and changes in economic forecasts (such as interest rates, unemployment rates and commodity prices) as well as weaknesses in underwriting identified after initial recognition.

3.4 The credit risk rating system should capture all lending exposures to allow for an appropriate differentiation of credit risk and grouping of lending exposures within the credit risk rating system, reflect the risk of individual exposures and, when aggregated across all exposures, the level of credit risk in the portfolio as a whole. In this context, an effective credit risk rating system will allow a licensee to identify both migration of credit risk and significant changes in credit risk.

3.5 In describing the elements of its credit risk rating system, a licensee should clearly define each credit risk grade and designate the personnel responsible for the design, implementation, operation and performance of the system as well as those responsible for periodic testing and validation (i.e. the independent review function).

3.6 Credit risk grades should be reviewed whenever relevant new information is received or a licensee's expectation of credit risk has changed. Credit risk grades assigned should receive a periodic formal review (at least annually) to reasonably ensure that those grades are accurate and up to date. Credit risk grades for individually assessed lending exposures that are higher-risk or credit-impaired should be reviewed more frequently than annually. ECL estimates must be updated on a timely basis to reflect changes in credit risk grades for either groups of exposures or individual exposures.

Grouping Based on Shared Credit Risk Characteristics

3.7 Groups should be sufficiently granular to allow licensees to group exposures into portfolios with shared credit risk characteristics so that licensees can reasonably assess changes in credit risk and thus the impact on the estimate of ECL. A licensee's methodology for grouping exposures to assess credit risk (such as by instrument type, product terms and conditions, industry/market segment, geographical location or vintages) should be documented and subject to appropriate review and internal approval.

3.8 Lending exposures should be grouped according to shared credit risk characteristics so that changes in the level of credit risk respond to the impact of changing conditions on a common range of credit risk drivers. This includes considering the effect on the group's credit risk in response to changes in forward-looking information, including macroeconomic factors. The basis of grouping should be reviewed to ensure that exposures within the group remain homogeneous in terms of their response to credit risk drivers. Grouping implemented upon initial recognition based on similar credit risk characteristics will not necessarily be appropriate subsequently, given that the relevant characteristics and their impact on the level of credit risk for the group may change over time.

3.9 Exposures must not be grouped in such a way that an increase in the credit risk of particular exposures is masked by the performance of the group as a whole.

3.10 Licensees should have in place a robust process to ensure appropriate initial grouping of their lending exposures. Subsequently, the grouping of exposures should be re-evaluated and exposures should be re-segmented if relevant new information is received or a licensee's changed expectations of credit risk suggest that a permanent adjustment is warranted. If a licensee is not able to re-segment exposures on a timely basis, a temporary adjustment may be used (see paragraphs 3.11 and 3.12 for use of temporary adjustments).

Use of Temporary Adjustments

3.11 Temporary adjustments to the allowance are adjustments which may be used to account for circumstances when it becomes evident that existing or expected risk factors have not been considered in the credit risk rating and modelling process. The Bank expects that such adjustments would be used only as a temporary solution – for example, in transient circumstances or when there is insufficient time to appropriately incorporate relevant new information into the existing credit risk rating system or to re-segment existing groups of lending exposures, or when lending exposures within a group react to factors or events differently than initially expected.

3.12 The use of temporary adjustments requires the application of significant judgment and creates the potential for bias. Temporary adjustments should be directionally consistent with forward-looking forecasts, supported by appropriate documentation, and subject to appropriate governance processes.

Principle 4 – Adequacy of the Allowance

A licensee's aggregate amount of allowances, regardless of whether allowance components are determined on a collective or an individual basis, should be adequate and consistent with the objectives of IFRS 9.

4.1 Licensees should implement sound and robust credit risk methodologies with the objective that the overall balance of the allowance for ECL is developed in accordance with IFRS 9 and adequately reflects ECL within that framework.

4.2 A robust assessment of allowances takes into account relevant factors and expectations at the reporting date that may affect the collectability of remaining cash flows over the life of a group of lending exposures or a single lending exposure. The information that licensees consider must go beyond historical and current data to consider relevant forward-looking information including macroeconomic factors that are relevant to the exposure being evaluated (e.g. retail or wholesale) in accordance with IFRS 9.[10]

4.3 Depending on the ability to incorporate forward-looking information into the ECL estimate, a licensee may use individual or collective assessment approaches; regardless, the approach should be consistent with the relevant accounting requirements. Together, individual and collective assessments form the basis for the allowance for ECL, and a licensee's use of individual versus collective assessments, if applied appropriately, should not result in materially different allowance measurements.

[10] See Principle 6 for guidance on the need for use of experienced judgment in the robust consideration of relevant and reasonable and supportable information, including forward-looking information.

4.4 The ECL estimation technique used should be the most appropriate in the particular circumstances, and typically should be aligned with how the licensee manages the credit risk exposure. For example, collective assessment is often used for large groups of homogeneous lending exposures with shared credit risk characteristics, such as retail portfolios. Individual ECL assessments are often conducted for significant exposures, or where credit concerns have been identified at the individual loan level, such as watch list and past-due loans. Regardless of the assessment approach it uses, a licensee must ensure this does not result in delayed recognition of ECL. Depending on the level of sophistication of a licensee's credit risk management systems, licensees may be challenged to incorporate the impact of forward-looking information, including macroeconomic forecasts, into assessments for individual borrowers, relying instead on collective assessments for a significant portion of their lending exposures, in order to incorporate forward-looking information.

4.5 When a licensee does use individual assessments, the ECL estimate should always incorporate the expected impact of all reasonable and supportable forward-looking information, including macroeconomic factors, that affects collectability and credit risk. When applying an individual assessment approach, the licensee's documentation (similarly to what is expected when performing a collective assessment) should clearly demonstrate how forward-looking information, including macroeconomic factors, has been reflected in the individual ECL assessment.

4.6 In instances where a licensee's individual assessments of exposures do not adequately consider forward-looking information, it is appropriate to group lending exposures with shared credit risk characteristics to estimate the impact of forward-looking information, including macroeconomic factors. This process allows identification of relationships between forward-looking information and ECL estimates that may not be apparent at the individual exposure level. Conversely, when licensees determine that all reasonable and supportable forward-looking information has been incorporated in the individual assessment of ECL, an additional forward-looking assessment should not be conducted on a collective basis if that could result in double-counting.

4.7 As noted in Principle 3, temporary adjustments may be necessary if the licensee's allowance methodology has not incorporated (or fully incorporated) events or circumstances not previously considered that affect ECL as of the reporting date. If the reason for the adjustment is not expected to be temporary, such as the emergence of a new risk driver that has not previously been incorporated into the licensee's allowance methodology, the methodology should be updated in the near term to incorporate the factor that is expected to have an ongoing impact on the measurement of ECL. It is not appropriate to continually use a temporary adjustment for a continuing risk factor over the long term.

Principle 5 – ECL Model Validation

A licensee should have policies and procedures in place to appropriately validate models used to assess and measure expected credit losses.

5.1 For the purposes of this guideline, a model is defined as "a quantitative method, system, or approach that applies statistical, economic, financial, or mathematical theories, techniques, and assumptions to process input data into quantitative estimates." (Board of Governors of the Federal Reserve System and the Office of the Comptroller of the Currency, 2011)[11] .

This definition includes quantitative approaches whose inputs are partially or wholly qualitative or based on expert judgment, provided that the output is quantitative in nature.

This definition does not obligate a licensee to develop complex statistical mechanisms in order to determine the ECL. Rather, the Bank expects that a licensee's ECL model will be commensurate with the size, nature and complexity of its operations.

5.2 ECL assessment and measurement may involve models and assumption-based estimates for risk identification and measurement. Models may be used in various aspects of the ECL assessment and measurement process at both the individual transaction and overall portfolio levels, including credit grading, credit risk identification, measurement of ECL allowances for accounting purposes, stress testing and capital allocation. ECL assessment and measurement models ("models") should consider the impact of changes to borrower and credit risk-related variables such as changes in PDs, LGDs, exposure amounts, collateral values, migration of default probabilities and internal borrower credit risk grades based on historical, current and reasonable and supportable forward-looking information, including macroeconomic factors.

5.3 As the development and use of ECL assessment and measurement models involves extensive judgment, effective model validation policies and procedures are crucial. A licensee should have robust policies and procedures in place to validate the accuracy and consistency of its model-based rating systems and processes and the estimation of all relevant risk components, at the outset of model usage and on an ongoing basis. Model validation should be conducted when the ECL models are initially developed and when significant changes are made to the models. A licensee should regularly (for example, annually) review its ECL models.

[11] This definition is available at https://www.federalreserve.gov/supervisionreg/srletters/sr1107.htm

5.4 A sound model validation framework should include, but not be limited to, the following elements:

a. Clear roles and responsibilities for model validation with adequate independence and competence. Model validation should be performed independently of the model development process and by staff with the necessary experience and expertise. Model validation involves ensuring that the models are suitable for their proposed usage, at the outset and on an ongoing basis. The findings and outcomes of model validation should be reported in a prompt and timely manner to the appropriate level of authority[12].

b. An appropriate model validation scope and methodology include a systematic process of evaluating the model's robustness, consistency and accuracy as well as its continued relevance to the underlying portfolio. An effective model validation process should also enable potential limitations of a model to be identified and addressed on a timely basis. The scope for validation should include a review of model inputs, model design and model outputs/performance.

   i. *Model Inputs* – The licensee should have internally established quality and reliability standards on data (historical, current and forward-looking information) used as model inputs. Data used to estimate ECL allowances should be relevant to the licensee's portfolios, and as far as possible accurate, reliable and complete (i.e. without exclusions that could bias ECL estimates). Validation should ensure that the data used meet these standards.

   ii. *Model Design* – For model design, validation should demonstrate that the underlying theory of the model is conceptually sound, recognised and generally accepted for its intended purpose. From a forward-looking perspective, validation should also assess the extent to which the model, at the overall model and individual risk factor level, can take into consideration changes in the economic or credit environment, as well as changes to portfolio business profile or strategy, without significantly reducing model robustness.

   iii. *Model Output/Performance* – The licensee should have internally established standards for acceptable model performance. Where performance thresholds are significantly breached, remedial actions to the extent of model re-calibration or re-development should be considered.

[12] Where a licensee has outsourced its validation function to an external party, the licensee remains responsible for the effectiveness of all model validation work and should ensure that the work done by the external party meets the elements of a sound model validation framework on an ongoing basis. See the Bank's Outsourcing Guideline.

c. Comprehensive documentation of the model validation framework and process. This includes documenting the validation procedures performed, any changes in validation methodology and tools, the range of data used, validation results and any remedial actions taken where necessary. Licensees should ensure that the documentation is regularly reviewed and updated.

d. A review of the model validation process by independent parties (e.g. the internal audit function or external parties[13]) to evaluate the overall effectiveness of the model validation process and the independence of the model validation process from the development process. The findings of the review should be reported in a prompt and timely manner to senior management and the Board.

Principle 6 – Experienced Credit Judgment

A licensee's use of experienced credit judgment, especially in the robust consideration of reasonable and supportable forward-looking information, including macroeconomic factors, is essential to the assessment and measurement of expected credit losses.

6.1 Licensees should have the necessary tools to ensure a robust estimate and timely recognition of ECL. Information on historical loss experience or the impact of current conditions may not fully reflect the credit risk in lending exposures. In that context, a licensee must use its experienced credit judgment to thoroughly incorporate the expected impact of all reasonable and supportable forward-looking information, including macroeconomic factors, on its estimate of ECL. A licensee's use of its experienced credit judgment must be documented in the licensee's credit risk methodology and subject to appropriate oversight.

6.2 Historical information provides a useful basis for the identification of trends and correlations needed to identify the credit risk drivers for lending exposures. However, ECL estimates must not ignore the impact of (forward-looking) events and conditions on those drivers. The estimate should reflect the expected future cash shortfalls resulting from such impact.

6.3 The Bank understands that it may be challenging and costly to incorporate forward-looking information in the estimate of ECL. Further, the Bank accepts that ECL is an estimate and thus may not perfectly predict actual outcomes. Accordingly, the need to incorporate such information is likely to increase the inherent degree of subjectivity in ECL estimates, compared with impairment measured using incurred loss approaches. In the Bank's view, consideration of forward-looking information is

[13] If an external auditor is engaged to undertake an audit of a licensee's financial statements and the independent review of the licensee's model validation process, a licensee should consider any potential conflicts of interest to ensure continued adherence to applicable auditor independence requirements.

essential to the proper implementation of an ECL accounting model, and should not be avoided on the basis that a licensee considers the cost of incorporating forward-looking information to be excessive or unnecessary or because there is uncertainty in formulating forward-looking scenarios. Nevertheless, the Bank does not expect additional cost and operational burden to be introduced where they do not contribute to a high-quality implementation of the IFRS 9 – ECL accounting framework.

6.4 Licensees should be able to demonstrate that the forward-looking information factored into the ECL estimation process has a link to the credit risk drivers for particular exposures or portfolios. For a variety of reasons, it may not be possible to demonstrate a strong link in formal statistical terms between certain types of information, or even the information set as a whole, and the credit risk drivers. Particularly in those circumstances, a licensee's experienced credit judgment will be crucial in establishing an appropriate level for the individual or collective allowance. When a forward-looking factor that has been identified as relevant is not incorporated into the individual or collective assessment, temporary adjustments may be necessary[14].

6.5 Macroeconomic forecasts and other relevant information should be applied consistently across portfolios where the credit risk drivers of the portfolios are affected by these forecasts/assumptions in the same way. Furthermore, when developing ECL estimates, a licensee should apply its experienced credit judgment to consider its point in the credit cycle, which may differ across the jurisdictions in which it has lending exposures.

6.6 The Bank expects licensees to exercise care when determining the level of ECL allowances to be recognised for accounting purposes to ensure that the resulting estimates are appropriate (i.e. consistent with neutrality and neither understated nor overstated).

6.7 Additionally, financial institutions are increasingly considering a wide range of information, including that of a forward-looking nature, for risk management and capital adequacy purposes. The Bank expects licensees to avail themselves of information derived from the different stages in the credit risk management process in developing their estimate of ECL.

Principle 7 – Common Data

A licensee should have a sound credit risk assessment and measurement process that provides it with a strong basis for common systems, tools and data to assess credit risk and to account for expected credit losses.

[14] See Principle 3 for additional guidance on the use of temporary adjustments.

7.1 There is commonality in the processes, systems, tools and data used to assess credit risk, measure ECL for accounting purposes and determine expected losses for capital adequacy purposes. The use of common processes, systems, tools and data strengthens, to the maximum extent possible, the consistency of the resulting estimates and minimises disincentives to following sound credit risk practices for all purposes.

7.2 A licensee's credit risk practices should meet fundamental requirements and procedures, including having the appropriate tools to identify and assess credit risk. These fundamental requirements are equally necessary for assessing credit risk and fairly representing the licensee's financial position for both accounting and capital adequacy purposes. These common processes are closely interrelated, which strengthens the reliability and consistency of resulting ECL estimates, increases transparency and, through market discipline, provides incentives to follow sound credit risk practices.

7.3 A licensee's credit risk monitoring system should be designed to include all lending exposures when assessing the impact of changes in credit risk, and not only those that may have experienced significant increases in credit risk, have incurred losses or are otherwise credit-impaired.

7.4 Credit risk practices should not be static and should be reviewed periodically to ensure that relevant data available throughout the organisation are captured and that systems are updated as the licensee's underwriting or business practices change or evolve over time. Moreover, a feedback loop should be established to ensure that information on estimates of ECL, changes in the credit risk and actual losses experienced on loans is shared among credit risk experts, accounting and regulatory reporting staff, and in particular with the loan underwriting personnel.

7.5 Common processes, systems, tools and data that are used in assessing credit risk and measuring ECL for accounting purposes and expected losses for capital adequacy purposes could include credit risk rating systems, estimated PDs (subject to appropriate adjustments), past-due status, loan-to-value ratios, historical loss rates, product type, amortisation schedule, down payment requirements, market segment, geographical location, vintage, and collateral type.

7.6 Estimates of ECL allowances may differ between licensees for various reasons; however, the Bank encourages the narrowing of different interpretations and practices as far as possible, through the application of consistent and sound credit risk practices.

Principle 8 – Disclosure

A licensee's public disclosures should promote transparency and comparability by providing timely, relevant and decision-useful information.

8.1 The objective of public disclosures is to provide decision-useful information, on an entity's financial position, performance and changes therein, to a wide range of users in a clear and understandable manner. The financial crisis highlighted the importance of high-quality disclosure, as investors criticised financial institutions for failing to provide sufficient relevant information on complex issues and risk management practices. The Bank encourages licensees to continue to improve their disclosure with the aim of providing information that is relevant and comparable so that users can make timely, informed decisions and are able to evaluate the stewardship of management.

8.2 Financial and credit risk management disclosures should be made in accordance with the applicable accounting and supervisory frameworks. Regulatory authorities, standard setters, investors, analysts and banks continue to assess the adequacy of disclosure frameworks and make amendments to improve the transparency and relevance of the information presented. Accordingly, it is important that licensees consider the disclosures needed to fairly depict their exposures to credit risk, including ECL estimates, and to provide relevant information on underwriting practices.

8.3 While remaining consistent with applicable accounting standards and regulations, management will need to apply judgment to determine the appropriate level of aggregation and disaggregation of data disclosed, such that disclosures continue to meet accounting requirements, and provide insights into a licensee's exposure to credit risk and ECLs for users to perform individual institution analysis and relevant peer group comparisons.

8.4 The Bank expects quantitative and qualitative disclosures, taken together, to communicate to users the main assumptions/inputs used to develop ECL estimates. Additionally, the Bank expects disclosures to highlight policies and definitions that are integral to the estimation of ECL (such as a licensee's basis for grouping lending exposures into portfolios with similar credit risk characteristics and its definition of default, guided by the definition used for regulatory purposes[15]), factors that cause changes in ECL estimates, and the manner in which management's experienced credit judgment has been incorporated. Disclosure of significant policies should be decision-useful and should describe, in the specific context of the licensee, how those policies have been implemented.

[15] See paragraphs A1.4–A1.5 in the Appendix for further guidance on definition of default.

8.5 The move to an ECL model requires that forward-looking information, including macroeconomic factors, be incorporated into ECL estimates (in accordance with IFRS 9). The Bank expects licensees to provide qualitative disclosures on how this information has been incorporated into the estimation process, in particular when the assessment is carried out on an individual basis.

8.6 A licensee's decisions regarding the basis for grouping lending exposures will normally reflect a combination of factors. The Bank expects disclosures in this area to communicate how management satisfies itself that lending exposures are appropriately grouped, such that these groups continue to share credit risk characteristics.

8.7 To improve the quality and meaningfulness of information disclosed for ECL estimates, the Bank expects licensees to provide an explanation of significant changes to the estimation of ECL from period to period. This information should include both relevant qualitative and quantitative disclosures in a manner that enhances the understanding of how ECL estimates have changed.

8.8 The Bank expects management to regularly review its disclosure policies to ensure that the information disclosed continues to be relevant to its risk profile, product concentrations, industry norms and current market conditions. In doing so, a licensee should aim to provide disclosures that facilitate comparisons with its peers. Such disclosures will enable users to monitor changes in the licensee's ECL estimates from period to period and allow users to perform meaningful analyses across peer groups.

Appendix

ADDITIONAL SUPERVISORY GUIDANCE

This Appendix provides additional supervisory expectations on: (i) the loss allowance at an amount equal to 12-month ECL; (ii) the assessment of significant increases in credit risk; and (iii) the use of practical expedients. The Appendix should be read in conjunction with the main section of the guidance, including the introductory sections that set out the Bank's view on reasonable and supportable information, materiality and proportionality.

A1. Loss Allowance at an Amount Equal to 12-Month ECL

A1.1. In accordance with IFRS 9, "if, at the reporting date, the credit risk on a financial instrument has not increased significantly since initial recognition, an entity shall measure the loss allowance for that financial instrument at an amount equal to 12-month expected credit losses"[16]. The Bank expects that a licensee will always measure ECL for all lending exposures, and that a nil allowance will be rare[17] because ECL estimates are a probability-weighted amount that should always reflect the possibility that a credit loss will occur[18].

A1.2. The Bank expects licensees to adopt an active approach to assessing and measuring 12-month ECL that enables changes in credit risk to be identified in a timely manner. In accordance with Principle 6 of the main section of this guidance, estimates of the amount and timing of 12-month ECL should reflect management's experienced credit judgment, and represent an unbiased probability weighted estimate of expected credit losses by considering a range of possible outcomes. The methodology used to estimate 12-month ECL should be robust at all times and should allow for the timely recognition of ECL.

A1.3. IFRS 9 defines an amount equal to 12-month ECL as the "portion of lifetime expected credit losses that represent the expected credit losses that result from default events on a financial instrument that are possible within the 12 months after the reporting date".[19] The Bank emphasises that an amount equal to the 12-month ECL is *not* only the losses expected in the next 12 months; rather, it is the expected cash shortfalls over the life of the lending exposure or group of lending exposures, due to loss events that could occur in the next 12 months. The Bank also emphasises that, to assess whether a financial instrument should move to a lifetime expected credit loss (LEL) measure, the change in the risk of a default occurring *over the expected life* of the financial instrument must be considered. In some circumstances, IFRS 9 allows

[16] See IFRS 9, paragraph 5.5.5.
[17] An example where a licensee may have a nil allowance is for fully collateralized loans. However, a licensee should be cautious when developing estimates of collateral value, as valuation of collateral at origination may change over the life of the loan.
[18] See IFRS 9, paragraph 5.5.17
[19] See IFRS 9, Appendix A, Defined Terms

changes in the risk of a default occurring over the next 12 months to be used to make this assessment; however, this may not always be appropriate, and particular attention is drawn to the examples set out in IFRS 9, paragraph B5.5.14.

A1.4. IFRS 9 does not directly define default, but requires entities to define default in a manner consistent with that used for internal credit risk management. IFRS 9, paragraph B5.5.37, also includes a rebuttable presumption that default does not occur later than 90 days past due. The Bank recommends that the definition of default adopted for accounting purposes is guided by the definition provided in paragraph 452 of the Basel capital framework (Basel Committee on Banking Supervision, 2006)[20]:

> "A default is considered to have occurred with regard to a particular obligor when either or both of the two following events have taken place.
>
> - The bank considers that the obligor is unlikely to pay its credit obligations to the banking group in full, without recourse by the bank to actions such as realising security (if held).
> - The obligor is past due more than 90 days on any material credit obligation to the banking group. Overdrafts will be considered as being past due once the customer has breached an advised limit or been advised of a limit smaller than current outstandings.[21]"

The Basel definition includes both a qualitative criterion and an objective indicator equivalent to the rebuttable presumption in IFRS 9, paragraph B5.5.37.

A1.5. In accordance with the Basel capital framework, a default event occurs when either of the criteria in paragraphs A1.4 (a) and (b) is met, or both are met. In this context, the "unlikeliness to pay" criterion of the debtor permits identification of default before the exposure becomes delinquent with the 90-days past-due criterion acting as a backstop. The list of elements provided in the Basel framework as indications of unlikeliness to pay should be implemented in a way that ensures a timely detection of "unlikeliness to pay" events that precipitate eventual cash shortfalls.

A1.6. In formulating the estimate of the amount equal to 12-month ECL, it is important to consider reasonable and supportable information[22] that affects credit risk, especially forward-looking information, including macroeconomic factors. A licensee should exercise its experienced credit judgment to consider both qualitative and quantitative information that may affect the licensee's assessment of credit risk. IFRS 9 provides that an entity need not undertake an exhaustive search for information when

[20] Available at https://www.bis.org/publ/bcbs128.pdf:
[21] Notwithstanding the above, the Bank will also consider as a default; cases where an overdraft account appears permanently overdrawn with no material fluctuations in the balance (i.e developed a hardcore).
[22] See "Consideration of reasonable and supportable information" in the "Application and Objective of this Guideline" section for the Bank's view on what constitutes reasonable and supportable information.

measuring an amount equal to 12-month ECL; nevertheless, licensees should actively incorporate information that may affect the estimate of ECL, and a licensee should not exclude or ignore relevant information that is reasonably available. For the measurement of an amount equal to 12-month ECL to be sufficiently sensitive to relevant drivers of credit risk, the Bank expects licensees to consider all reasonable and supportable information that is reasonably available, without bias, and known to affect the assessment and measurement of credit risk. This will permit the timely recognition of ECL in response to changes in credit risk and better reflect the inherent credit risk associated with lending. The Bank acknowledges that IFRS 9 requires that the information used in measuring ECL is that which is available without undue cost and effort. Paragraph A3.3 sets out the Bank's views on this concept.

A1.7. IFRS 9 requires licensees to identify significant increases in credit risk since initial recognition for all financial instruments, including those measured at 12-month ECL. IFRS 9 includes the option of making assumptions about low credit risk exposures, the application of which is addressed in paragraphs A3.4 – A3.7 below. The measurement of an amount equal to 12-month ECL must be updated each reporting period, and any changes to this amount are to be recorded and monitored through the allowance account.

A1.8. The Bank expects that, where a licensee originates high-credit-risk exposures[23] and their allowances are initially measured at 12-month ECL, the licensee should monitor these exposures closely for significant increases in credit risk to ensure a timely movement of the exposure to LEL measurement. That is because high-risk exposures are likely to exhibit greater volatility and to more readily experience a rapid decline in credit risk. Where a licensee has a policy that allows it to extend credit for high-risk lending exposures, the Bank expects that the rationale for extending these exposures and associated governance process will be well documented, and that the licensee will be in adherence to sound underwriting practices and implement commensurately robust credit risk management practices.

A1.9. An amount equal to 12-month ECL measurement may be determined on an individual or collective basis. The Bank expects that a robust implementation of the IFRS 9 ECL requirements, taking into account the migration of credit risk, will allow increases in credit risk to be reflected in increased allowances well before exposures move, either individually or collectively, to LEL measurement.

A1.10. Even if an increase in credit risk is not judged to be significant, a licensee must adjust its estimate of 12-month ECL to adequately reflect changes in credit risk that have taken place.

[23] The reference to "high credit risk" exposures should not be understood, in the context of this paragraph, as meaning the opposite of "low credit risk" as defined by the IASB

A1.11. Where a collective assessment is performed, exposures within that group must adhere to the requirements set out in Principle 3. In particular, where information becomes available to management indicating that further or different segmentation within a group of lending exposures is required, the group should be split into subgroups and the measurement of the amount equal to 12-month ECL should be updated separately for each subgroup[24] or, in the case of transient circumstances, a temporary adjustment should be applied[25].

A1.12. Lending exposures should *not* be grouped in such a way as to obscure the identification of significant increases in credit risk on a timely basis. See also Principles 3 and 4 for additional requirements regarding grouping and collective assessments of ECL.

A2. Assessment of Significant Increases in Credit Risk

A2.1 IFRS 9, paragraph 5.5.4 states: "The objective of the impairment requirements is to recognise LEL for all financial instruments for which there have been significant increases in credit risk since initial recognition – whether assessed on an individual or collective basis – considering all reasonable and supportable information, including that which is forward-looking."

A2.2 The Bank understands that the rationale for this approach is that the creditworthiness of the counterparty, and thus the ECL anticipated upon initial recognition, is taken into account in the pricing of credit at that time.[26] It follows, then, that a post-origination increase in credit risk may not be fully compensated by the interest rate charged, and, as a consequence, a licensee must carefully consider whether there has been a significant increase in credit risk.[27] If so, the lending exposure would be subject to LEL measurement.

A2.3 The IFRS 9 approach to impairment assessment and measurement is demanding in its requirements for data, analysis and use of experienced credit judgment, particularly regarding whether an exposure has suffered a significant increase in credit risk and the measurement of required 12-month ECL and LEL. In the Bank's view, strong governance, systems and controls must be placed around these processes. Unless already established, licensees will need to implement systems that are capable of

[24] Where information becomes available which indicates that a particular subgroup has suffered a significant increase in credit risk, then lifetime expected credit losses should be recognized in respect of that subgroup
[25] See paragraphs 3.1 – 3.2 for guidance on the use of temporary adjustments
[26] See, for example, IASB, Project summary on IFRS 9, July 2014, page 20, which notes that "[w]hen credit is first extended the initial creditworthiness of the borrower and initial expectations of credit losses are taken into account in determining pricing and other terms and conditions" and that "[a] true economic loss arises when expected credit losses exceed initial expectations (i.e. when the lender is not receiving compensation for the level of credit risk to which it is now exposed)".
[27] The Bank notes that IFRS 9 requires entities to consider a wide range of factors in assessing for significant increases in credit risk and that pricing may be one of those factors.

handling and systematically assessing the large amounts of information that will be required to judge whether or not particular lending exposures or groups of lending exposures exhibit a significant increase in credit risk, and to measure LEL where that is the case. Ensuring that the approach is consistent across entities within a consolidated group is important. For example, processes should be in place to ensure that forecasts of economic conditions in different jurisdictions and economic sectors are reviewed and approved by an entity's senior management, and that the process, controls and economic assumptions around developing forecasts and linking these to expectations of credit loss are consistent across the entity (i.e. at the jurisdictional and the group level). The need for consistency should not be interpreted as a requirement that the practice be identical across a group. On the contrary, within a consistent framework there may be differences across jurisdictions and products, depending for instance on the availability of data. These differences should be well documented and justified.

A2.4 The IFRS 9 objective stated above means that the timely determination of whether there has been a "significant" increase in credit risk subsequent to the initial recognition of a lending exposure is crucial. Licensees must have processes in place that enable them to determine this on a timely and holistic basis so that an individual exposure, or a group of exposures with similar credit risk characteristics, is transferred to LEL measurement as soon as credit risk has increased significantly, in accordance with the IFRS 9 impairment accounting requirements.

A2.5 As noted in the IFRS 9 Application Guidance, the range of information that will need to be considered in making this determination is wide. In broad terms, it will include information on macroeconomic conditions, and the economic sector and geographical region relevant to a particular borrower or a group of borrowers with shared credit risk characteristics, in addition to borrower-specific strategic, operational and other characteristics. A critical feature is the required consideration of all reasonable and supportable forward-looking information in addition to information about current conditions and historical data.[28]

A2.6 In order to recognise allowances on a timely basis in line with the IFRS 9 requirements, licensees will need to:

a. assemble data and forward projections for the key drivers of credit risk in their portfolios; and

b. be able to quantify the credit risk in each of their exposures or portfolios based on these data and projections. This will both enable management

[28] IFRS 9 requires that information included in the measurement of ECL and the assessment of changes in credit risk is available without undue cost and effort. The Bank's views on this concept for licensees are set out in paragraph A3.3.

to judge whether there has been a significant increase in credit risk, and form a key input to the measurement of ECL and allowances.

A2.7 The Bank strongly endorses the IASB's view that "lifetime expected credit losses are generally expected to be recognised before a financial instrument becomes past due" and that "typically, credit risk increases significantly before a financial instrument becomes past due or other lagging borrower-specific factors (for example a modification or renegotiation) are observed".[29] Therefore it is important that licensees' analyses take into account the fact that the determinants of credit losses very often begin to deteriorate a considerable time (months or, in some cases, years) before any objective evidence of delinquency appears in the lending exposures affected. Delinquency data are generally backward-looking, and the Bank believes that they will seldom on their own be appropriate in the implementation of an ECL approach by licensees, consistent with IFRS 9.

A2.8 For example, within retail portfolios adverse developments in macroeconomic factors and borrower attributes will generally lead to an increase in the level of credit risk long before this manifests itself in lagging information such as delinquency. Thus, the Bank believes that, in order to meet the objective of IFRS 9 in a robust manner, licensees will need to consider the linkages between macroeconomic factors and borrower attributes to the level of credit risk in a portfolio based on reasonable and supportable information. To that end, licensees should start with a detailed analysis of historical patterns and current trends, which would allow for identification of the most relevant credit risk drivers. Experienced credit judgment should facilitate the incorporation of current and forecasted conditions likely to affect those risk drivers, the expected cash shortfalls and therefore loss expectations.

A2.9 The Bank expects analyses of this kind to be performed not only in the context of portfolios of individually small credits, such as credit card exposures, but also for large, individually managed exposures. For example, for a large commercial property loan, licensees should take account of the considerable sensitivity of the commercial property market in many jurisdictions to the general macroeconomic environment, and consider using information such as levels of interest rates or vacancy rates to determine whether there has been a significant increase in credit risk.

A2.10 Licensees must have a clear policy including well developed criteria on what constitutes a "significant" increase in credit risk for different types of lending exposures. Such criteria and the reasons why these approaches and definitions are considered appropriate should be disclosed in accordance with IFRS 7, paragraph 35F. IFRS 9, paragraph 5.5.9, requires that, when making the assessment of significant increases in credit risk, "an entity shall use the change in the risk of default occurring over the

[29] See IFRS 9, paragraph B5.5.2.

expected life of the financial instrument instead of the change in the amount of expected credit losses". In other words, this assessment is made in terms of the risk of a default occurring and not expected credit loss (i.e. before consideration of the effects of credit risk mitigants such as collateral or guarantees).

A2.11 In developing their approach to determining a significant increase in credit risk, the Bank expects licensees to consider each of the 16 classes of indicators in IFRS 9 (insofar as they are relevant to the financial instrument being assessed) as set out in paragraphs B5.5.17 (a)–(p) and, in addition, to consider whether there is further information that should be taken into account. Such indicators (in both IFRS 9 and this guidance) should not be viewed as a "checklist". Some will be more relevant than others to assessing whether a particular type of exposure exhibits a significant increase in credit risk. At the same time, licensees should take particular care to avoid the risk of a significant increase in credit risk not being acknowledged promptly when it is, in fact, present. In particular, licensees should not restrict significant increases in credit risk to situations when a financial instrument is anticipated to move to the third stage. Rather, debtors may exhibit a significant increase in credit risk without evidence that the related exposures are likely to become impaired. The fact that credit risk has increased significantly does not necessarily mean that default is probable – merely that it is more likely than at initial recognition. This point is underlined by the symmetry of the IFRS 9 model: it is possible for exposures to move to LEL but subsequently be moved back to 12-month ECL if the threshold of a significant increase in credit risk is no longer met.

A2.12 While it is neither possible nor desirable for universally applicable criteria to be developed, the Bank emphasises that particular consideration should be given to conditions (a)–(f) below in assessing a significant increase in credit risk:

a. a discretionary decision by management such that, were an existing loan newly originated at the reporting date, the element of the price of the loan that reflects the credit risk of the exposure would be significantly higher than it was when the loan was actually originated because of an increase in the credit risk of the specific borrower or class of borrowers since inception;

b. a decision by management to strengthen collateral and/or covenant requirements for new exposures that are similar to exposures already advanced because of changes in the credit risk of those exposures since initial recognition;

c. a downgrade of a borrower by a recognised credit rating agency, or within a licensee's internal credit rating system;

d. for performing credits subject to individual monitoring and review, an internal credit assessment summary credit-quality indicator that is weaker than upon initial recognition;

e. deterioration of relevant determinants of credit risk (e.g. future cash flows) for an individual obligor (or pool of obligors); and

f. expectation of forbearance[30] or renegotiation due to financial difficulties.

Most of the factors listed above are related to a licensee's credit risk management practices. While implementation of IFRS 9 should reflect such practices where possible, the Bank notes that in some cases that would not be appropriate. For example, in a case where a licensee manages most exposures in the same way regardless of credit risk – with the exception only of particularly strong or weak credits – the manner in which an exposure is managed is unlikely to be a sound indicator of whether there has been a significant increase in credit risk.

A2.13 In addition, the assessment of whether there has been a significant increase in credit risk for a lending exposure should take account of the more general factors below:

a. deterioration of the macroeconomic outlook relevant to a particular borrower or group of borrowers. Macroeconomic assessments must be sufficiently rich to include factors relevant to sovereign, corporate, household and other types of borrower. Furthermore, they must address any relevant regional differences in economic performance within a jurisdiction. See Principle 6 in the main section of this guidance for additional considerations regarding guidance on the consideration of forward-looking information, including macroeconomic factors; and

b. deterioration of prospects for the sector or industries within which a borrower operates.

A2.14 Accurate identification of drivers of credit risk, and reliable demonstration of the linkages between those drivers and the level of credit risk, are both critical, as a seemingly small change in a qualitative characteristic of a loan can potentially be a leading indicator of a large increase in the risk of a default occurring. Furthermore, IFRS 9, paragraph 5.5.9, states that the significance of a change in credit risk since

[30] "Forbearance occurs when:
- a counterparty is experiencing **financial difficulty** in meeting its financial commitments; and
- a bank grants a **concession** that it would not otherwise consider, whether or not the concession is at the discretion of the bank and/or the counterparty. A concession is at the discretion of the counterparty (debtor) when the initial contract allows the counterparty (debtor) to change the terms of the contract in its own favour (embedded forbearance clauses) due to financial difficulty." (Basel Committee on Banking Supervision, 2017)

initial recognition depends on the risk of a default occurring at initial recognition. In this regard, where a licensee uses changes in probability of default (PD) as a means of identifying changes in the risk of a default occurring, the significance of a given change in PD can be expressed in a ratio (or the rate of fluctuation) proportionate to the PD at initial recognition (i.e. a change in the PD divided by the PD at initial recognition). However, the Bank also acknowledges that the width of the change in PD itself (i.e. PD at measurement date minus PD at initial recognition) should also be taken into consideration.

A2.15 It is necessary to look beyond how many “grades” a rating downgrade entails because the change in PD for a one-grade movement may not be linear (for example, the default probability over five years of an exposure rated BB is around three times that of one rated BBB, based on current data and analyses applicable to certain jurisdictions). Furthermore, because the significance of a one-grade movement would depend on the granularity of a licensee’s rating system – and hence the “width” of each grade – an appropriate initial segmentation is important to ensure that a significant increase in credit risk for an individual exposure or group of exposures is not masked within a segment. As such, a licensee should ensure that credit risk rating systems include a sufficient number of grades to appropriately distinguish credit risk. A licensee should also be mindful of the fact that a significant increase in credit risk could occur prior to a movement in a credit grade.

A2.16 There are some circumstances in which an adverse movement in the factors listed in paragraphs A2.12–A2.14 above might not be indicative of a significant increase in credit risk. For example, it may be the case that the default probability of an exposure rated AA is low, and not much greater than one rated AAA. However, very few licensee loans are of such apparently low credit risk – and, as noted in paragraph A2.15, the sensitivity of default probability to rating grades may increase strongly as rating quality declines.

A2.17 There could also be circumstances in which some factors move in an adverse direction but may be counterbalanced by improvement in others (see IFRS 9 Illustrative Examples, Example 2). Nonetheless, in view of the importance of detecting whether there has been a significant increase in credit risk, the Bank stresses that licensees must put in place governance processes capable of reliably validating any judgment that negative factors are counterbalanced by positive ones.

A2.18 The Bank stresses that thorough consideration and full weight must be given to discretionary decisions by a licensee’s management which point to a change in credit risk. For example, if because of concerns about credit risk a decision is made to intensify the monitoring of a borrower or class of borrowers, it is unlikely that such action would have been taken by the decision-maker had the increase in credit risk not been perceived as significant.

A2.19 Sometimes a licensee will assess that there has been significant increase in credit risk for some, but not all, of its exposures to a counterparty. While it is possible for this to be the case – for example, because of differences in the timing of when lending was provided – particular care should be taken in this situation to ensure that all exposures are identified where there has been a significant increase in credit risk.

A2.20 Where a licensee makes the assessment of significant increases in credit risk on a collective basis (i.e. such as retail), the definitions of portfolios must be reviewed regularly to ensure that the exposures within them continue to share risk characteristics in terms of their response to credit risk drivers. Changing economic conditions may require regrouping. Exposures must not be grouped in such a way that an increase in the credit risk of some individual exposures could be obscured by changes in the credit risk of the portfolio as a whole.

A2.21 IFRS 9, paragraph B5.5.1, states that, in order to meet the objective of recognising LEL for significant increases in credit risk since initial recognition, it may be necessary for the assessment to be performed on a collective basis by considering information that is indicative of significant increases in credit risk in a group or subgroup of financial instruments even if evidence of such significant increases in credit risk at the individual instrument level is not yet available. Accordingly, the Bank expects that, in instances where it is apparent that some exposures in a group have experienced a significant increase in credit risk, that a subset or a proportion of the group will transfer to LEL measurement of ECL even though it is not possible to identify this on an individual exposure basis (see IFRS 9, Illustrative Example 5).

A2.22 Consistent with paragraph B5.5.6 of IFRS 9 and paragraph IE39 of the Implementation Guidance for IFRS 9, if it is not possible on the basis of shared credit risk characteristics to identify a particular subgroup of borrowers for which credit risk has increased significantly, an appropriate proportion of the overall group should be subject to LEL measurement.

A2.23 “Significant” should not be equated with statistical significance, meaning that the assessment approach should not be based solely on quantitative analysis. For portfolios which have a large number of individually small credits, and a rich set of relevant historical data, it may be possible to identify “significant” increases in credit risk in part by utilising formal statistical techniques. However, for other exposures, that may not be feasible.

A2.24 “Significant” should also not be judged in terms of the extent of impact on a licensee’s primary financial statements. Even where an increase in credit risk defined in terms of probability of default is unlikely to affect the allowance made – for example, because the exposure is more than fully collateralised – identification and disclosure of such increases are likely to be important to users seeking to understand trends in the intrinsic credit risk of a licensee’s loans.

A2.25 The IASB ECL model is a relative model: the assessment of significant increases in credit risk is based on comparing credit risk on exposures at the reporting date relative to credit risk upon initial recognition. IFRS 9, paragraph BC5.161, and Illustrative Example 6 suggest that licensees can set a maximum credit risk for particular portfolios upon initial recognition that would lead to that portfolio moving to LEL measurement when credit risk increases beyond that maximum level. This is an example of the application of the principle in the Standard, whereby changes in the risk of default need to be assessed relative to that upon initial recognition, rather than an exception to that principle. The Bank notes that this simplification is only relevant when exposures are segmented on a sufficiently granular basis such that a licensee can demonstrate that the analysis is consistent with the principles of IFRS 9. Specifically, it would be necessary to demonstrate that a significant increase in credit risk had not occurred for items in the portfolio before the maximum credit grade was reached.

A2.26 The Bank expects licensees to develop ways of rigorously reviewing the quality of their approach to assessing whether credit risk has increased significantly. This could involve some form of analysis of the treatment of exposures through time. Management should consider whether there are additional factors that should be taken into account in the assessment of significant increases in credit risk which would improve the quality of their approach.

A2.27 Licensees should be alert to any possibility of bias being introduced that would prevent the objectives of the Standard from being met. For this reason, the Bank is of the view that, in order to implement IFRS 9 in a robust manner, practical expedients (see A3) should have limited use by licensees, as these have the potential to introduce significant bias. For example, as outlined at A3, use of a 30-days-past-due criterion introduces bias leading to a move to LEL later than the objective of the Standard requires.

A2.28 In cases where licensees believe that their approach to implementation is likely to have introduced bias, they should correct their assessment for identified bias and thus ensure that the objective of the Standard is met (see in particular IFRS 9, paragraphs B5.5.1–B5.5.6).

A2.29 IFRS 9, in paragraphs 5.5.12 and B5.5.25–B5.5.27, sets out the requirements for the assessment of significant increases in credit risk for lending exposures whose contractual cash flows have been renegotiated or modified. In particular, for modifications that do not result in de-recognition in accordance with IFRS 9, a licensee must assess whether credit risk has increased significantly by comparing (a) the risk of a default occurring at the reporting date based on the modified contractual terms with (b) the risk of default occurring upon initial recognition based on the original, unmodified contractual terms.

A2.30 Modifications or renegotiations can mask increases in credit risk, resulting in ECL being underestimated, and delaying the transfer to LEL for obligors whose credit risk has significantly deteriorated, or can inappropriately result in a move from LEL measurement back to 12-month ECL measurement.

A2.31 When determining whether there is a significant increase in credit risk for a modified lending exposure, the Bank expects a licensee to demonstrate whether such modifications or renegotiations have improved or restored the ability of the licensee to collect interest and principal payments compared with the situation upon initial recognition. In developing ECL estimates, a licensee should also take into account whether the modification or renegotiation has improved or restored the ability of the licensee to collect interest and principal payments as compared with the situation prior to modification. Consideration should also be given to the substance of modified contractual cash flows as well as the implications of the modifications for the future credit risk of the exposure (taking into consideration the obligor's credit risk). Factors to consider include, but are not limited to, the following:

a. whether the modification or renegotiation of the contractual terms and resulting cash flows is economically beneficial to the obligor, compared with the original, unmodified contractual terms, and how the modification economically affects the obligor's ability to repay the debt;

b. whether factors can be identified that support a licensee's assessment of the obligor's ability to repay the debt, including circumstances leading up to the modification, and future prospects of the obligor as a result of the modifications, considering current conditions, macroeconomic forecasts, and prospects for the sector/industry within which the obligor operates, the obligor's business model, and the obligor's business (management) plan that outlines the obligor's expectations of its future performance, financial resilience and cash flows; and

c. whether the obligor's business plan is feasible, realisable and consistent with the repayment schedule of interest and principal under the modified contractual terms of the lending exposure.

A2.32 Exposures transferred to LEL that are subsequently renegotiated or modified, and not de-recognised, should not move back to 12-month ECL measurement unless there is sufficient evidence that the credit risk over the life of the exposure has not increased significantly compared with that upon initial recognition. For example, where a licensee grants various concessions such as interest rate reductions or postponements of principal repayments to obligors in financial difficulty, the lending exposure may exhibit characteristics of a lower credit risk even though in reality the obligor may continue to experience financial difficulty with no realistic prospects of making scheduled repayments over the remaining term of the exposure. IFRS 9 notes that evidence that the criteria for the recognition of LEL are no longer met could include a history of up-to-date and timely payment performance against the modified contractual terms. Typically, a customer would need to demonstrate consistently good payment behaviour over a period of time before the credit risk is considered to have decreased. For example, a history of missed or incomplete payments would not typically be erased by simply making one payment on time following a modification of the contractual terms.

A3. Use of Practical Expedients

A3.1. IFRS 9 includes a number of practical expedients, intended to ease the implementation burden for a wide range of companies in recognition of the fact that IFRS 9 will be used by a variety of entities, including firms outside the banking industry. The Bank expects that the use by deposit taking licensees of the practical expedients discussed in the paragraphs that follow will be limited, particularly because – given their business – the cost of obtaining relevant information is not considered by the Bank to be likely to involve "undue cost or effort".

A3.2. The paragraphs below address the following practical expedients: limiting the information set which an entity must consider in measuring ECL; the exception for "low" credit risk exposures; and the 30-days-past-due rebuttable presumption. In instances where these exceptions from the core requirements of the Standard are applied, the Bank expects that justifications for the use of such practical expedients by licensees should be clearly documented. They will be subject to increased scrutiny by supervisors to determine appropriateness.

The Information Set

A3.3. IFRS 9 states that "an entity shall consider the best reasonable and supportable information that is available, without undue cost and effort" and that "an entity need not undertake an exhaustive search for information".[31] The Bank expects that licensees will not read these statements restrictively. Since the objective of the IFRS 9 model is to deliver fundamental improvements in the measurement of credit losses, the Bank expects licensees to develop systems and processes that use all reasonable and supportable information that is relevant to the group or individual exposure, as needed to achieve a high-quality, robust and consistent implementation of the approach. This will potentially require costly upfront investments in new systems and processes but the Bank considers that the long-term benefit of a high-quality implementation far outweighs the associated costs, which should therefore not be considered undue. Nevertheless, the Bank does not expect additional cost and operational burden to be introduced where they do not contribute to a high-quality implementation of IFRS 9.

[31] IFRS 9, paragraph B5.5.15.

"Low Credit Risk" Exemption[32]

A3.4. IFRS 9 introduces an exception to the general model in that, for "low credit risk" exposures, entities have the option not to assess whether credit risk has increased significantly since initial recognition. It was included to reduce operational costs for recognising LEL on financial instruments with low credit risk at the reporting date. Although use of the low-credit-risk exemption is provided as an option in IFRS 9, the Bank expects that use of this exemption should be limited. In particular, it expects licensees to conduct timely assessment of significant increases in credit risk for all lending exposures. In the Bank's judgment, use of this exemption by licensees for the purpose of omitting the timely assessment and tracking of credit risk would reflect a low-quality implementation of the ECL model and IFRS 9.

A3.5. In that context, the Bank expects that licensees should always recognise changes in 12-month ECL through the allowance where there is not a significant increase in credit risk and a move to LEL measurement if there is a significant increase in credit risk. In the Bank's view, in order to achieve a high-quality implementation of IFRS 9, any use of the low-credit-risk exemption must be accompanied by clear evidence that credit risk as of the reporting date is sufficiently low that a significant increase in credit risk since initial recognition could not have occurred.

A3.6. According to IFRS 9, paragraph B5.5.22, the credit risk on a financial instrument is considered low if:

a. the financial instrument has a low risk of default;

b. the borrower has a strong capacity to meet its contractual cash flow obligations in the near term; and

c. adverse changes in economic and business conditions in the longer term may, but will not necessarily, reduce the ability of the borrower to fulfil its contractual cash flow obligations.

A3.7. To illustrate the meaning of low credit risk, IFRS 9, paragraph B.5.5.23, cites as an example an instrument with an external "investment grade" rating. The Bank is of the view that this is only an example and that all lending exposures that have an "investment grade" rating from a credit rating agency cannot automatically be considered low credit risk. The Bank expects licensees to rely primarily on their own credit risk assessments in order to evaluate the credit risk of a lending exposure, and not to rely solely or mechanistically on ratings provided by credit rating agencies (where the latter are available). Nevertheless, optimistic internal credit ratings, as

[32] See IFRS 9, paragraph B5.5.22.

compared with external ratings, would require additional analysis and justification by management.

More-Than-30-Days-Past-Due Rebuttable Presumption

A3.8. The Bank agrees with the view expressed in IFRS 9 that delinquency is a lagging indicator of significant increases in credit risk. Banks should have credit risk assessment and management processes in place to ensure that credit risk increases are detected well ahead of exposures becoming past due or delinquent. As noted in paragraphs A2.7 and A2.27, the Bank expects that a licensee would not use the more-than-30-days-past-due rebuttable presumption as a primary indicator of transfer to LEL, while recognising that appropriate use of this rebuttable presumption as a backstop measure would not be precluded in accordance with IFRS 9 alongside other, earlier indicators for assessing significant increase in credit risk.

A3.9. The Bank expects that any assertion that the more-than-30-days-past-due presumption is rebutted on the basis that there has not been a significant increase in credit risk will be accompanied by a thorough analysis clearly evidencing that 30 days past due is not correlated with a significant increase in credit risk. Such analysis should consider both current and reasonable and supportable forward-looking information that may cause future cash shortfalls to differ from historical experience.

A3.10. In this regard, the Bank expects a licensee to use relevant forward-looking information that is reasonable and supportable, to analyse whether there is any substantive relationship between such information and credit risk drivers. The Bank expects that a licensee will not use the 30-days-past-due rebuttable presumption unless it has demonstrated that the forward-looking information had no substantive relationship with the credit risk driver or such information is not available without undue cost or effort.

A3.11. In the limited instances where past-due information is the best criterion available to a licensee to determine when exposures should move to the LEL category, banks should pay particular attention to their measurement of 12-month ECL allowance to ensure that ECL are appropriately captured in accordance with the measurement objective of IFRS 9. Moreover, licensees should recognise that significant reliance on backward-looking information will introduce bias into the implementation of an ECL model and that the Bank expects licensees to pay particular attention to ensuring that the objectives of the IFRS 9 impairment requirements (i.e. to reflect ECL that meet the stated measurement objectives and to capture all significant increases in credit risk) are met.

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