THE BAHAMAS INSTITUTE OF CHARTERED ACCOUNTANTS

GUIDANCE NOTE

To:	The Bahamas Institute of Chartered Accountants (BICA) Membership and Industry Practitioners
Date:	September 12, 2019
From:	BICA Technical Committee
Subject:	IFRS 9 Impairment Analysis – Bahamas Sovereign Debt

Contents

1   Objective of Guidance Note

International Financial Reporting Standard 9: *Financial Instruments* ("IFRS 9" or "the Standard") requires that financial assets that are not measured at Fair Value through Profit and Loss (FVTPL) be assessed for credit losses.

IFRS 9 is effective for annual periods beginning on or after January 1, 2018 and so an entity shall analyse the financial instruments for impairment at the reporting date consistent with the new standard.

The purpose of this Guidance Note is to document considerations to be given to financial instruments, in particular sovereign debt instruments under IFRS 9 in analysing and recording the appropriate impairment where applicable.

This Guidance Note includes sections/topics which require judgement and assumptions, and the ultimate responsibility as it relates to concluding on these areas lies with an entity's management.

2   Background

If all financial instruments were measured at FVTPL there would be no need for any impairment requirements as any exposure to credit risk would be reflected in the instrument's fair value and recognised immediately in profit or loss. However, under IFRS 9, a number of financial instruments that expose an entity to credit risk are not measured at FVTPL and for these instruments an impairment model is necessary to appropriately recognise credit losses on a timely basis.

Under IFRS 9, an 'expected loss' impairment model applies which requires a loss allowance to be recognised based on expected credit losses.

2.1   Types of Investments commonly held

Some investments commonly held by local entities are summarised below into the following types and classifications:

Investment Type	Classification	In Scope for Impairment
Managed/Mutual Funds	FVTPL	No
Common Equity Securities	FVTPL	No
Fixed Income Securities	FVTOCI or Amortized Cost	Yes
Bahamas Government Debt	FVTOCI or Amortized Cost	Yes
Bank/Term Deposits	Amortized Cost	Yes
Private Equity Funds	FVTPL	No

The analysis set out in this memo is focused on the measurement of expected credit losses for holdings of Bahamas Government (Govt.) debt securities.

3   Analyse the issue

3.1   Scope and General Approach

Under IFRS 9 an entity shall recognise a loss allowance for expected credit losses on a financial asset that is measured at amortised cost or at fair value through other comprehensive income.

Conclusion: IFRS 9 classification is based on business model and cashflow characteristics. In general, we would expect most holdings in Bahamas Govt. debt to be within the scope of the Standard's impairment requirements. Generally, holdings follow the approach of recognizing 12-month expected credits losses unless, at the reporting date, the credit risk has increased significantly since initial recognition, in which case lifetime expected credit losses would be recognized.

3.2   Significant increase in credit risk ("SICR") analysis

Under IFRS 9, the change in credit risk is a measure of the change in the risk of a default occurring over the expected life of the financial instrument.

There are a variety of approaches that could be used to assess whether the credit risk on a financial instrument has increased significantly since initial recognition. The International Accounting Standards Board (IASB, or 'the Board') did not intend to prescribe a specific or mechanistic approach to assess changes in credit risk and the appropriate approach will vary for different levels of sophistication of entity, the nature of the financial instrument and the availability of data.

However, the Board has also confirmed that the use of the term 'probability of a default' ("PfD") occurring is intended to capture the concept of the risk of a default occurring and that using a probability of default measure is one way in which an increase in credit risk could be assessed.

3.2.1   Undue cost or effort related to forward looking information

IFRS 9 notes that information used in the assessment should be available to the entity without undue cost or effort. Consequently, if reasonable and supportable forward-looking information is available without undue cost or effort, an entity cannot rely solely on past due information when determining whether credit risk has increased significantly since initial recognition. However, when such information is not available without undue cost or effort (either on an individual or a collective basis), an entity may use past due information to determine whether there has been significant increases in credit risk since initial recognition.

For the Bahamas Govt. debt held, it should be noted that the Bahamas Govt. has never defaulted on its non-agency debt. However, there are publicly available data that can still be used, including the incorporation of certain assumptions that would allow an entity to assess credit risk using forward looking information. Note that:

-     Credit ratings are available for the Bahamas Govt.;
-     Rating agencies issue publicly available probability of default rates by credit rating;
-     There is qualitative information regarding macro-economic factors affecting the Sovereign that could be used to adjust market factors; and
-     Other country-specific indicators such as credit default spreads are not available for Bahamas or similar Caribbean countries as these are not actively traded.

Conclusion: There is reasonable and supportable forward looking information available such that past due information should not be relied upon for assessing changes in credit risk. Certain assumptions will be required to use and/or adjust market wide observable data in order to reflect the credit risk associated with the Bahamas Govt. debt.

However, one may use the presumption that if any holdings in Bahamas Govt. debt are more than 30 days past due, a significant increase in credit risk is deemed to have occurred [See **IFRS 9 Section 5.5.11** for guidance on this rebuttable presumption].

3.2.2   Low risk assumption

As noted above in [IFRS 9:5.5.10] if the financial instrument is determined to have low credit risk at the reporting date, the entity may assume there has been no SICR.

The objective of the low credit risk simplification is to provide operational relief for high quality financial instruments, in other words, those with a low risk of default. [IFRS 9:BC5.186(b)].

IFRS 9:B5.5.23 discusses the methods that could be used for determining whether an instrument has low credit risk, stating that '[a]n external rating of 'investment grade' is an example of a financial instrument that may be considered as having low credit risk'.

Consequently, an entity can use external credit ratings to determine whether an instrument has low credit risk, provided that the credit rating:

- is specific to the financial instrument being evaluated (i.e. takes into account all of its terms and conditions of the financial instrument as required in IFRS 9:B5.5.23);
- does not reflect the value of any collateral (as discussed in IFRS 9:B5.5.22, the assessment to be made is whether the instrument has a low risk of default rather than whether it has a low loss given default (LGD)); and
- is current at the reporting date, i.e. the rating must reflect the economic conditions prevailing at the reporting date. If there is a time lag between the last update date and the reporting date, consideration should be given to whether economic events affecting the issuer since the publication of the rating would not lead to a sub-investment grade assessment.

The credit ratings from Moody's and Standard & Poor's (S&P) can be used to assess the Bahamas Govt. debt. Currently the Bahamas debt has both an investment grade (Baa3 – Moody's) and non-investment grade (BB+ - S&P). In August 2017, Moody's assessment included a "Negative" outlook, but in February 2019, Moody's changed the Bahamas' outlook to Stable.

Conclusion: As there have been differences in the rating conclusions of the two largest external rating agencies, there is no clear consensus whether the Bahamas Govt. debt has low credit risk. Considering the requirement to consider forward looking information and due to the investment grade rating by Moody's with a previously negative outlook and non-investment rating by S&P, it would be reasonable prudent to conclude not to use the low risk assumption. Nonetheless, given that the SICR determination is dependent on initial recognition, this may be different for each reporting entity, at different points in time, and for different instruments.

3.2.3   12-month PfD as a proxy for Lifetime PfD

For financial instruments for which default patterns are not concentrated at a specific point during the expected life of the financial instrument, changes in the risk of a default occurring over the next 12 months may be a reasonable approximation of the changes in the lifetime risk of a default occurring and could be used to determine whether credit risk has increased significantly since initial recognition. [IFRS 9:B5.5.13]

The appropriateness of using changes in the risk of a default occurring over the next 12 months to determine whether lifetime expected credit losses should be recognised will depend on the specific facts and circumstances. For example, it may not be a suitable basis for determining whether credit risk has increased on a financial instrument with a maturity of more than 12 months when: [IFRS 9:B5.5.14]

1. the financial instruments only have significant payment obligations beyond the next 12 months;
2. changes in relevant macroeconomic or other credit-related factors occur that are not adequately reflected in the risk of a default occurring in the next 12 months; or
3. changes in credit-related factors only have an impact on the credit risk of the financial instrument (or have a more pronounced effect) beyond 12 months.

Conclusion: If the maturity dates of the Bahamas Govt. debt being analysed have maturity dates with wide ranges, using the 12-month PfD as a proxy is not deemed appropriate.

3.2.4   Method for assessing SICR

An entity will be required to assess whether there has been a SICR using reasonable and supportable information. Potential key observable data inputs are;

- External credit ratings that are specific to Bahamas credit risk
- Global market average default rates by credit rating
- Additional qualitative information available on economic environment in Bahamas

Credit Ratings:

Due to the fact that there is limited market data in The Bahamas or the wider Caribbean region and the secondary market is very thin, entities holding Bahamian sovereign debt continue to consider the international external rating agencies (Moody's, Standards & Poor's & Fitch Ratings Inc.) as the more relevant reference points for purposes of determining the expected credit losses (ECL) estimation inputs used in calculating the PfD, LGD, and in ascertaining significant increases (or otherwise) in credit risk of financial instruments[1] since initial recognition.

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[1] For the purposes of this Guidance Note, financial instruments were limited to sovereign debt (e.g. Bahamas Government Registered Stock).

In accordance with IASB's Appendix to IFRS 9, paragraph B5.5.23, to determine whether a financial instrument has low credit risk, an entity may use its internal credit risk ratings or other methodologies that are consistent with a globally understood definition of low credit risk and that consider the risks and the type of financial instruments that are being assessed. An external rating of 'investment grade' is an example of a financial instrument that may be considered as having low credit risk.

Rating Definitions as per External Agencies:

i)   Moody's

Ratings assigned on Moody's global long-term and short-term rating scales are forward looking opinions of the relative credit risks of financial obligations issued by financial entities.

Moody's classifies its long-term debt ratings into two categories;
- I.   Investment Grade(Aaa-Baa3)
- II.   Speculative Grade(Ba1-C)

See Moody's Rating Table/Definitions in Appendix A

ii)   Standards and Poor's (S&P)

Standards & Poor's (S&P) ratings definitions are classified into two types;

- I.   General Purpose Credit Ratings
  Includes rating definitions for both short & long term for both issuer and issue ratings. These types of credit ratings cover the broadest set of credit risk factors.
- II.   Special Purpose Ratings
  These ratings relate to specific groups of entities such as capital market transactions.

For the purpose of this Guidance Note, our assessment covers General Purpose Long Term Credit Ratings.

See S&P Rating Table/Definitions in Appendix A

iii)   Fitch Rating Agency

Fitch utilizes the same rating scales as those agencies identified above by using the symbols (AAA-D) to measure the financial strength of the securities. However, they also use modifiers "+" or "- "to denote relative status within major rating categories. Fitch refers to the ratings as Issuer Default Ratings (IDRs) and it is their belief that these IDRs provide an ordinal ranking of issuers based on the agency's view of their relative vulnerability to default rather than a prediction of a specific percentage likelihood of default.

See Fitch Rating Table/Definitions in Appendix A

While using external credit ratings is deemed a reasonable reference point for purposes of estimating the ECL on financial instruments, the following are the key additional considerations that should be incorporated in an entity's model:

I. Credit ratings outlook – potential direction of a rating over the intermediate term (a one to two-year period). The outlook provides information about the potential evolution of a rating; hence, it increases the precision of the rating. For example, for rating agencies such as Moody's, Fitch and Standard & Poor's, has categorized the outlook as follows:
   a. positive means that a rating may be raised or improved;
   b. negative means that a rating may be lowered or further downgraded;
   c. stable means that a rating is not likely to change; and
   d. developing (or evolving) means that a rating may be raised, lowered, or affirmed

II. Any down-grades (historical or recent) of a given sovereign by the external rating agencies – lowering of the rating in the scale, for example, due to bankruptcy filings, restructurings/re-organization, blacklists, etc. For the financial instruments held prior to the down grade of the Bahamas sovereign, considerations should be given for lifetime ECL assessments.

Disclosure requirements on Credit Ratings

IFRS S 7R.35M| Credit risk exposure:

To enable users of financial statements to assess an entity's credit risk exposure and understand its significant credit risk concentrations, an entity shall disclose, by credit risk rating grades, the gross carrying amount of financial assets and the exposure to credit risk on loan commitments and financial guarantee contracts. This information shall be provided separately for financial instruments:

   a. for which the loss allowance is measured at an amount equal to 12-month expected credit losses;

   b. for which the loss allowance is measured at an amount equal to lifetime expected credit losses and that are:

        i) financial instruments for which credit risk has increased significantly since initial recognition but that are not credit-impaired financial assets;

        ii) financial assets that are credit-impaired at the reporting date (but that are not purchased or originated credit-impaired); and

        iii) trade receivables, contract assets or lease receivables for which the loss allowances are measured in accordance with paragraph 5.5.15 of IFRS 9.

   c. that are purchased or originated credit-impaired financial assets.

3.3   SICR assessment for Bahamas Govt. Debt

3.3.1   Qualitative Assessment

Note that any security purchased prior to 14th December 2011 has experienced 3 credit rating downgrades, and therefore it is appropriate to perform a qualitative assessment to determine if there has been a SICR.

Note the following characteristics of the Bahamas economic environment and specific qualitative factors regarding the Government debt;

- The Govt. debt has significant liquidity in the economy due to exchange controls.
- Tourism sector has been growing and providing basis for GDP growth in the country. Recent IMF report (10th December 2018) stated "The Bahamian economy continues to recover, with real GDP growth projected to reach 2.3 percent in 2018 and 2.1 percent in 2019. Growth is driven by an increase in tourist arrivals, paired with an expansion of hotel room and airlift capacity, and against the backdrop of the continued expansion of the U.S. economy. This calls for maintaining strong fiscal and financial policies to bolster the Bahamian economy's resilience and build buffers should external conditions become less favorable, and for advancing reforms to achieve more inclusive growth over the medium term."
- Majority of government debt is held by local holders with little debt held by foreign debt holders. The credit ratings published are in relation to the externally held debt and different market characteristics are involved for the locally held debt.
- Banking system has "strong capital and liquidity ratios". IMF report "As of June 2018, the average capital to risk-weighted assets ratio across domestic institutions was 34 percent, above the regulatory target ratio of 17 percent, and non-performing loans declined to 9.6 percent of total loans, from 12.3 percent a year earlier."
- Liquidity and demand for Govt. debt can be seen in current market price – note 47 out of 53 holdings have a market price exceeding par value. For the 6 holdings below, these range from 98.7-99.5 illustrating no significant decrease in market value.
- Unemployment rate has decreased over the last 10 years (since 2009).

Conclusion: Due to the qualitative assessment showing no signs of significant increase in credit risk, the liquidity in the market, coupled with the market price consistent at around the par value, it is reasonable to conclude that whilst there have been downgrades to the Country's external credit rating this has not impacted the assessment that there has been no significant increase in credit risk on the locally held debt. Further, in line with market practice, Moody's credit rating is noted as currently most advantageous. As there is not consensus between the two agencies and there are only two ratings available, it would be punitive to take the worst case.

4   Current Market Practice

There is significant ongoing discussion regarding approaches to IFRS 9 impairment on Bahamas Govt. debt. Key considerations include;

- No history or evidence of default or restructuring (but individual government agencies may have delayed satisfying (or relied on the central government to satisfy) obligations which constitutes technical default); nonetheless an argument can be made that the Government does have ample reserves to meet its debt obligations.

This is noted as corroborative evidence that the low risk assumption should not be used.

Regarding the factors considered when assessing the credit risk:

- Credit ratings: publicly available and published (e.g. Moody's and S&P); consideration given to investment grade (generally above BBB- or Baa) or non-investment grade, taking most advantageous rating of those assigned by the various rating agencies.
- Probability of Default (PfD) publication relied on as a key source of input detailing global discount experience based on defaults in other countries concluding on a consensus that 0% is not appropriate, but that given lack of history of default less than 1% is likely.
- Loss Given Default (LGD) publication also relied on as a key source of input provided actual haircuts on government debt restructuring, excluding global outliers.
- Qualitative factors when considering the macro-economic conditions which affect likelihood and magnitude of default (exposure at default) include GDP growth and unemployment. Other factors such as inflation were considered, but to avoid double counting, it ultimately was not factored in as there tends to be a strong correlation between it and GDP/unemployment.

Macro-economic factors such as GDP growth and unemployment were considered when determining if there has been a SICR following observation of the credit rating downgrades causing a trigger.

5 Measurement of Expected Credit Loss (ECL)

Expected credit losses are a probability-weighted estimate of credit losses (i.e. the present value of all cash shortfalls) over the expected life of the financial instrument. For financial assets, a credit loss is the present value of the difference between:

[IFRS 9:B5.5.29]

- the contractual cash flows that are due to an entity under the contract; and
- the cash flows that the entity expects to receive.

IFRS 9:5.5.18 makes clear that an entity cannot simply assume that the most likely outcome is payment of the contract in full and therefore expected credit losses are nil. Such an approach does not include the probability assessment of the possibility that a credit loss could occur. The aim of a probability-weighted approach in IFRS 9 is to ensure that credit losses, regardless of how likely, form part of the measurement of the loss allowance.

In December 2015 the IASB's Transition Resource Group for Impairment of Financial Instruments discussed whether forward-looking information used for determining significant increases in credit risk should be consistently applied in measuring expected credit losses. It was noted that there should be consistency between the two except when forward-looking information is relevant to one but not the other.

An entity should identify a methodology used for measuring the ECL for the Bahamas Govt. in line with the key principles from IFRS 9:5.5.17.

5.1.1 Probability-weighted outcome

The purpose of estimating expected credit losses is neither to estimate a worst-case scenario nor to estimate the best-case scenario. Instead, an estimate of expected credit losses always reflects the possibility that a credit loss occurs and the possibility that no credit loss occurs even if the most likely outcome is no credit loss. [IFRS 9:B5.5.41].

This does not need to be a complex analysis. In some cases, relatively simple modelling may be sufficient, without the need for a large number of detailed simulations of scenarios. For example, the average credit losses of a large group of financial instruments with shared risk characteristics may be a reasonable estimate of the probability-weighted amount.

6 Methodology for Expected Credit Loss calculation

A general approach to the calculation of ECL may be:

$$(12m) \ ECL = (12m)Pfd \times LGD \times EAD$$

$$(Lftm) \ ECL = (Lftm)Pfd \times LGD \times EAD$$

6.1 Inputs & Assumptions

6.1.1 Probability of defaults (Pfd)

To determine the probability of default to be used in an entity's ECL calculation, market studies performed by rating agencies regarding corporate default rates by credit rating may be useful. These are observable inputs that are widely used in practice to estimate the PfD for an entity based on their credit rating.

Given these are corporate rates, an uplift to the published PfD is likely required to account for the country-specific credit risk premium for the Bahamas that is not considered in the Global corporate averages.

6.1.2 Loss Given Default (LGD)

Loss given default, or LGD, is an estimate of the ultimate loss incurred by a reporting entity once a counterparty enters into default. LGD varies by type of counterparty, type and seniority of claim and availability of collateral or other credit support. LGD is expressed as a percentage loss per unit of exposure at the time of default (i.e. exposure at default, or 'EAD').

When there is insufficient, possibly biased internal data or few, if any, actual observed losses, then reporting entities will generally then use a combination of both internal and external data for similar portfolios of financial instruments to estimate LGD. If external

data is used, it will be key to consider how relevant this data is for a specific financial instrument and its risk characteristics and whether any adjustments are required.

Each reporting entity should determine its methodology for developing an LGD for each class of financial instrument to which it is exposed to credit risk. The methodology should consider:

- Appropriate segmentation to capture shared credit risk characteristics;
- Historical cash recoveries upon default;
- Appropriate application of forward looking variables;
- Appropriateness of the underlying data used to develop the loss given default; and
- Appropriateness of the recovery period considered to calculate cash shortfalls.

Note: Published default tables and recovery rates for LGD are updated regularly and as such, the most updated information should always be used.

Staging

LGD is calculated either on a 12-month (Stage 1) or lifetime basis (Stage 2 and 3), where 12-month LGD is the percentage of loss expected to be made if the default occurs in the next 12 months and lifetime LGD is the percentage of loss expected to be made if the default occurs over the remaining expected lifetime of the exposure. Under IFRS 9, that determination is based on whether the financial instrument at the reporting date has experienced a significant increase in credit risk since initial recognition (SICR). This determination of SICR should be based on reasonable and supportable information.

For example, in assessing LGD for sovereign debt (such as Bahamas Government Registered Stock, or 'BGRS'), external credit rating agencies may provide useful published information pertaining to the current credit risk of a specific issuer of sovereign debt as well as worldwide historical defaults on sovereign debt. Instruments with low credit risk are widely considered to fall within the category of "investment grade". Therefore, non-investment grade may be an indication that an instrument has experienced a SICR and should therefore have the instrument's estimated lifetime LGD applied in the expected credit loss model. Instruments which have defaulted and are considered credit-impaired reflect missed contractual payments, partial payments, or deferred payments and are also subject to lifetime LGDs. Judgment is required to assess the appropriateness of SICR as external credit rating agencies have come to different conclusions on whether The Bahamas's sovereign debt is considered investment grade as this may have significant implications to a company's expected credit loss model.

To determine historical default rates, Moody's data show historical recovery rates on worldwide sovereign debt defaults have averaged 55%, implying an LGD of 45%. For reporting entities holding Bahamas sovereign debt, given the fact that the Government of The Bahamas has never defaulted, it may be helpful to assess the LGDs of countries within the Caribbean region or that have economies of similar size and/or composition. Judgment is involved in any adjustments made by management to such externally available data, such as whether, and on what basis, outliers might be removed from the dataset.

Finally, when determining LGD, an entity should consider an LGD cure rate (i.e. the probability of defaulted instruments (Stage 3) improving and reverting to a non-default status (Stage 1 or 2)).

Forward looking variables

For LGD, consideration should be given to the availability of data that best reflects possible future impacts on recoverability. For example, growth rates in gross domestic product (GDP) may broadly influence the recovery rate of debt financial assets in default. It is often the case that macroeconomic variables tend to be highly correlated (for instance, GDP growth may also positively influence the unemployment rate); therefore, the most predictive variable should be considered in the calculation of ECL. In sophisticated models, the impact of the economic variables on LGD may also be determined by performing statistical regression analysis to understand the impact changes in these variables have had on historical LGDs.

Each forward looking variable should be subject to a probability-weighting based on management's judgement of which outcomes are expected (or most likely) under at least three possible scenarios, if not more. Estimating expected outcomes is not intended to reflect a "worst case" or "best case" scenario but instead whether there is a realistic probability of a credit loss occurring.

6.2   Disclosure considerations

Entities must explain the inputs, assumptions and estimation techniques used to apply the requirements of IFRS 9. This includes an explanation of:

(a) the <u>basis of inputs and assumptions and the estimation techniques</u> used to:

    (i) measure the 12-month and lifetime expected credit losses;

    (ii) determine whether the credit risk of financial instruments have increased significantly since initial recognition; and

    (iii) determine whether a financial asset is a credit-impaired financial asset.

(b) *how* <u>forward-looking information has been incorporated</u> into the determination of expected credit losses, including the use of macroeconomic information; and

(c) <u>changes in the estimation techniques or significant assumptions</u> made during the reporting period and the reasons for those changes.

Any significant judgements made or key assumptions in the expected credit loss model that have a significant effect on the financial statements should be described and disclosed in accordance with IAS 1 *Presentation of financial statements*.

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7   APPENDICES

7.1   **Appendix A** - *Review relevant Literature*

IFRS 9 chapter 5.5 describes the requirements with respect to the impairment assessment performed on financial instruments and other credit exposures. Where relevant throughout, references to the standard have been included.

Relevant reference
[5.5.1] *An entity shall recognise a loss allowance for expected credit losses on a financial asset that is measured in accordance with paragraphs 4.1.2 or 4.1.2A…* **[5.5.2] An entity shall apply the impairment requirements for the recognition and measurement of a loss allowance for financial assets that are measured at fair value through other comprehensive income in accordance with paragraph 4.1.2A. However, the loss allowance shall be recognised in other comprehensive income and shall not reduce the carrying amount of the financial asset in the statement of financial position.** **[5.5.3] ……at each reporting date, an entity shall measure the loss allowance for a financial instrument at an amount equal to the lifetime expected credit losses if the credit risk on that financial instrument has increased significantly since initial recognition.**

Recognition of expected credit losses

The impairment approach in IFRS 9 is based on expected credit losses. Therefore, it is not necessary for a loss event to occur before credit losses are recognised. Instead, a loss allowance is always recognised for expected credit losses and is remeasured at each reporting date for changes in those expected credit losses.

Relevant reference
[5.5.4] The objective of the impairment requirements is to recognise lifetime expected credit losses 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. **[5.5.5] ….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.**

Determining whether a loss allowance should be based on 12-month expected credit losses or lifetime expected credit losses depends on whether there has been a significant increase in credit risk of the financial instrument since initial recognition (or the commitment date).

Given the difference between 12-month and lifetime expected credit losses, the concept of a significant increase in credit risk is fundamental to the application of the general approach. Consequently, there is a significant amount of guidance included in the Standard to help determine whether there has been a significant increase in credit risk since the initial recognition of a financial asset.

Therefore, the general approach has two bases on which to measure expected credit losses:

- lifetime expected credit losses are the expected credit losses that result from all possible default events over the expected life of a financial instrument; and
- 12-month expected credit losses are the portion of the 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.

Significant increase in credit risk

Whether the loss allowance is based on 12-month expected credit losses or lifetime expected credit losses will depend on whether, at the reporting date, there has been a significant increase in credit risk since initial recognition. A significant increase in credit risk is not a defined term and it will require significant judgment to apply this term in practice.

[5.5.9] At each reporting date, an entity shall assess whether the credit risk on a financial instrument has increased significantly since initial recognition. When making the assessment, an entity shall use the change in the risk of a default occurring over the expected life of the financial instrument instead of the change in the amount of expected credit losses. To make that assessment, an entity shall compare the risk of a default occurring on the financial instrument as at the reporting date with the risk of a default occurring on the financial instrument as at the date of initial recognition and consider reasonable and supportable information, that is available without undue cost or effort, that is indicative of significant increases in credit risk since initial recognition.

[5.5.10] An entity may assume that the credit risk on a financial instrument has not increased significantly since initial recognition if the financial instrument is determined to have low credit risk at the reporting date.

[5.5.11] If reasonable and supportable forward-looking information is available without undue cost or effort, an entity cannot rely solely on past due information…

…However, when information that is more forward-looking than past due status (either on an individual or a collective basis) is not available without undue cost or effort, an entity may use past due information to determine whether there have been significant increases in credit risk since initial recognition...

…there is a rebuttable presumption that the credit risk on a financial asset has increased significantly since initial recognition when contractual payments are more than 30 days past due.

Given that a significant increase in credit risk since initial recognition is a relative measure, a given change, in absolute terms, in the risk of a default occurring will be more significant for a financial instrument with a lower initial risk of a default occurring compared to a financial instrument with a higher initial risk of a default occurring.

Measurement of expected credit losses

[5.5.17] An entity shall measure expected credit losses of a financial instrument in a way that reflects:

   a)   an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes;
   b)   the time value of money; and
   c)   reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions.

[5.5.18] When measuring expected credit losses, an entity need not necessarily identify every possible scenario. However, it shall consider the risk or probability that a credit loss occurs by reflecting the possibility that a credit loss occurs and the possibility that no credit loss occurs, even if the possibility of a credit loss occurring is very low.

7.2   **Appendix B -** *Rating Tables/Definitions*

Moody's Rating Table

Global Long-Term Rating Scale

Aaa   Obligations rated Aaa are judged to be of the highest quality, subject to the lowest level of credit risk.

Aa   Obligations rated Aa are judged to be of high quality and are subject to very low credit risk.

A   Obligations rated A are judged to be upper-medium grade and are subject to low credit risk.

Baa   Obligations rated Baa are judged to be medium-grade and subject to moderate credit risk and as such may possess certain speculative characteristics.

Ba Obligations rated Ba are judged to be speculative and are subject to substantial credit risk.

B Obligations rated B are considered speculative and are subject to high credit risk.

Caa Obligations rated Caa are judged to be speculative of poor standing and are subject to very high credit risk.

Ca Obligations rated Ca are highly speculative and are likely in, or very near, default, with some prospect of recovery of principal and interest.

C Obligations rated C are the lowest rated and are typically in default, with little prospect for recovery of principal or interest.

Source: https://www.moodys.com/ratings-process/Ratings-Definitions/002002

S&P Rating Table

Long-Term Issue Credit Ratings*	
Category	**Definition**
AAA	An obligation rated 'AAA' has the highest rating assigned by S&P Global Ratings. The obligor's capacity to meet its financial commitments on the obligation is extremely strong.
AA	An obligation rated 'AA' differs from the highest-rated obligations only to a small degree. The obligor's capacity to meet its financial commitments on the obligation is very strong.
A	An obligation rated 'A' is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligations in higher-rated categories. However, the obligor's capacity to meet its financial commitments on the obligation is still strong.
BBB	An obligation rated 'BBB' exhibits adequate protection parameters. However, adverse economic conditions or changing circumstances are more likely to weaken the obligor's capacity to meet its financial commitments on the obligation.
BB, B, CCC, CC, and C	Obligations rated 'BB', 'B', 'CCC', 'CC', and 'C' are regarded as having significant speculative characteristics. 'BB' indicates the least degree of speculation and 'C' the highest. While such obligations will likely have some quality and protective characteristics, these may be outweighed by large uncertainties or major exposure to adverse conditions.
BB	An obligation rated 'BB' is less vulnerable to nonpayment than other speculative issues. However, it faces major ongoing uncertainties or exposure to adverse business, financial, or economic conditions that could lead to the obligor's inadequate capacity to meet its financial commitments on the obligation.
B	An obligation rated 'B' is more vulnerable to nonpayment than obligations rated 'BB', but the obligor currently has the capacity to meet its financial commitments on the obligation. Adverse business, financial, or economic conditions will likely impair the obligor's capacity or willingness to meet its financial commitments on the obligation.
CCC	An obligation rated 'CCC' is currently vulnerable to nonpayment and is dependent upon favorable business, financial, and economic conditions for the obligor to meet its financial commitments on the obligation. In the event of adverse business, financial, or economic conditions, the obligor is not likely to have the capacity to meet its financial commitments on the obligation.
CC	An obligation rated 'CC' is currently highly vulnerable to nonpayment. The 'CC' rating is used when a default has not yet occurred but S&P Global Ratings expects default to be a virtual certainty, regardless of the anticipated time to default.

Long-Term Issue Credit Ratings*	
Category	**Definition**
C	An obligation rated 'C' is currently highly vulnerable to nonpayment, and the obligation is expected to have lower relative seniority or lower ultimate recovery compared with obligations that are rated higher.
D	An obligation rated 'D' is in default or in breach of an imputed promise. For non-hybrid capital instruments, the 'D' rating category is used when payments on an obligation are not made on the date due, unless S&P Global Ratings believes that such payments will be made within five business days in the absence of a stated grace period or within the earlier of the stated grace period or 30 calendar days. The 'D' rating also will be used upon the filing of a bankruptcy petition or the taking of similar action and where default on an obligation is a virtual certainty, for example due to automatic stay provisions. A rating on an obligation is lowered to 'D' if it is subject to a distressed exchange offer.

*Ratings from 'AA' to 'CCC' may be modified by the addition of a plus (+) or minus (-) sign to show relative standing within the rating categories.

Source:https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352

Fitch Rating Table

Rating	Definition
AAA-Highest Credit Quality	'AAA' ratings denote the lowest expectation of default risk. They are assigned only in cases of exceptionally strong capacity for payment of financial commitments. This capacity is highly unlikely to be adversely affected by foreseeable events.
AA: Very high credit quality	'AA' ratings denote expectations of very low default risk. They indicate very strong capacity for payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.
A: High credit quality.	'A' rating denote expectations of low default risk. The capacity for payment of financial commitments is considered strong. This capacity may, nevertheless, be more vulnerable to adverse business or economic conditions than is the case for higher ratings.
BBB: Good credit quality	'BBB' ratings indicate that expectations of default risk are currently low. The capacity for payment of financial commitments is considered adequate, but adverse business or economic conditions are more likely to impair this capacity.
BB: Speculative.	'BB' ratings indicate an elevated vulnerability to default risk, particularly in the event of adverse changes in business or economic conditions over time; however, business or financial flexibility exists that supports the servicing of financial commitments.

Rating	Definition
B: Highly speculative.	'B' ratings indicate that material default risk is present, but a limited margin of safety remains. Financial commitments are currently being met; however, capacity for continued payment is vulnerable to deterioration in the business and economic environment.
CCC: Substantial credit risk.	Default is a real possibility.
CC: Very high levels of credit risk	Default of some kind appears probable.
C: Near default	A default or default-like process has begun, or the issuer is in standstill, or for a closed funding vehicle, payment capacity is irrevocably impaired. Conditions that are indicative of a 'C' category rating for an issuer include:

a. the issuer has entered into a grace or cure period following non-payment of a material financial obligation;

b. the issuer has entered into a temporary negotiated waiver or standstill agreement following a payment default on a material financial obligation;

c. the formal announcement by the issuer or their agent of a distressed debt exchange;

d. a closed financing vehicle where payment capacity is irrevocably impaired such that it is not expected to pay interest and/or principal in full during the life of the transaction, but where no payment default is imminent

Rating	Definition

RD: Restricted default.	'RD' ratings indicate an issuer that in Fitch's opinion has experienced:
	
	  a. an uncured payment default on a bond, loan or other material financial obligation, but
	
	  b. has not entered into bankruptcy filings, administration, receivership, liquidation, or other formal winding-up procedure, and
	
	  c. has not otherwise ceased operating.
	
	This would include:
	
	  i. the selective payment default on a specific class or currency of debt;
	
	  ii. the uncured expiry of any applicable grace period, cure period or default forbearance period following a payment default on a bank loan, capital markets security or other material financial obligation;
	
	  iii. The extension of multiple waivers or forbearance periods upon a payment default on one or more material financial obligations, either in series or in parallel; ordinary execution of a distressed debt exchange on one or more material financial obligations.

D: Default.	'D' ratings indicate an issuer that in Fitch's opinion has entered into bankruptcy filings, administration, receivership, liquidation or other formal winding-up procedure or that has otherwise ceased business.

Source: https://www.fitchratings.com/site/definitions - Rating definition pdf file.