Meeting of the G20 Finance Ministers and Central Bank Governors
15-16 February 2013
Update by the IASB and FASB

Convergence projects

As requested, this report is a high-level update on the status and timeline of the remaining convergence projects. This includes an update on the impairment phase of our joint project on financial instruments (included in the appendices to this report).

Background

In the past ten years, since the US Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (the boards) signed the Norwalk Agreement in 2002, we have made remarkable progress in improving and converging major global accounting standards. In 2006, the boards agreed a Memorandum of Understanding (MoU) that identified several short-term and longer-term convergence projects that would bring the most significant improvements to IFRS and US GAAP. The MoU was updated in 2008 and then again in 2010.

Achievements and challenges

Most of the short-term projects and several of the longer-term projects have been completed or are nearing completion. In 2012 the boards made significant progress on the remaining joint projects and they continue to appreciate the importance of developing converged accounting standards. The boards have achieved converged solutions for Revenue Recognition accounting and will be exposing converged proposals for accounting for Leases. There have, however, been some challenges to developing completely converged solutions, especially for the Impairment and Insurance Contracts projects.

For the Impairment project, it has been a challenge to bring together the different perspectives of the boards' respective stakeholders and the different markets in which such stakeholders conduct their primary business activities. While the goal continues to be the development of a converged Standard for impairment, the extent of future convergence in this project will depend, in part, on the feedback that is received during the boards' respective comment periods. However, it is also important to note that under both sets of proposals the provisions for loan losses continue to be based on the same information set, updated for changes in loss expectations.

Developing a converged solution for the Insurance Contracts project may be more difficult. IFRS does not currently include accounting requirements for insurance contracts, so the IASB needs a final Standard urgently and will be undertaking a targeted re-exposure of its proposals. The FASB has existing models for insurance contracts but will initially be exposing proposed amendments for public comment in mid-2013. The difference in the

scope of the questions in these exposure documents and the need for the IASB to issue timely guidance will make achieving a fully converged solution for the Insurance Contracts project challenging.

Financial instruments

Classification and Measurement

During 2012, the boards worked together to eliminate differences in their respective classification and measurement models and have converged decisions in the following areas:

- Contractual Cash Flow Characteristics Assessment: a financial asset would be eligible for a measurement category other than fair value through profit or loss if the contractual terms of the financial asset give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding, where interest is consideration for the time value of money and for credit risk.

- Business Model Assessment: the assessment of the business model would apply to those financial assets that 'pass' the assessment of the contractual cash flow characteristics. Financial assets would qualify for amortised cost accounting if the assets are held within a business model whose objective is to hold the assets in order to collect contractual cash flows. The frequency and nature of sales would prohibit some financial assets from qualifying for amortised cost.

- Fair value through other comprehensive income: financial assets would be measured at fair value through other comprehensive income if they 'pass' the assessment of the contractual cash flow characteristics and are held within a business model whose objective involves both holding the financial assets to collect contractual cash flows and selling financial assets.

- Fair value through profit or loss would be the residual measurement category that would include all assets that 'fail' the assessment of the contractual cash flow characteristics.

Given the different stages of development of the classification and measurement phases of their respective projects, (the IASB is making limited amendments to IFRS 9 *Financial Instruments* whereas the FASB is proposing completely new guidance), the boards' exposure documents will not be identical.

The IASB published its Exposure Draft in November 2012. These proposed amendments were intended to further align the boards' classification models, address some of the insurance community's concerns about the interaction with accounting for insurance contracts, and clarify the existing classification and measurement requirements for financial assets. The comment period ends on 28 March 2013.

The FASB expects to issue a second Exposure Draft on classification and measurement in February 2013 and will conduct outreach with stakeholders during the exposure period. The comment period will end on 30 April 2013.

The boards are planning to begin joint redeliberations about the feedback received on the proposals later this year. The timing of the issuance of final requirements will depend on the nature and extent of the feedback received.

Impairment (Loan Loss Provisioning)

This is probably the most important phase of our project to overhaul the accounting for financial instruments. While the boards worked jointly to develop an 'expected loss' approach to impairment, US stakeholders raised numerous concerns about early drafts of the so-called 'three-bucket' approach. The most significant concerns related to the use of two different measurement approaches—a portion of the expected losses for all new or purchased financial assets[1] and a full loss recognition approach for financial assets that have exhibited 'more than insignificant deterioration'. The FASB believed it was necessary to address these concerns before moving to an Exposure Draft.

To address these concerns, the FASB developed a different expected loss model whereby at each reporting date, an entity would recognise an allowance for credit losses for its current estimate of all expected credit losses on financial assets held at the reporting date. The same objective applies to all financial assets held in any period; however, the measure of the allowance would be commensurate with the current assessment of risk for the financial assets held.

In late December 2012 the FASB published its Exposure Draft. The FASB's comment period ends on 30 April 2013.

The IASB decided to maintain the concept of the 'three-bucket' approach but will revise it to address concerns that had been raised about the point at which full lifetime expected losses should be recognised. The revised model will result in an initial recognition of a portion of the lifetime expected losses, with full lifetime expected losses being recognised only once a financial asset significantly deteriorates (ie to the point that an economic loss is suffered beyond the level that was originally anticipated and priced into the financial asset).

The IASB is aware of the importance of publishing its proposals as soon as possible, and will publish an Exposure Draft in the first quarter of 2013. There will be a 120-day comment period.

The boards appreciate the importance of converged requirements in this area and continue to have open lines of communication. However, as noted above, challenges to achieving a converged solution include bringing together the different needs of the respective boards' stakeholders and the different markets in which such stakeholders conduct their primary

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[1] In the Impairment section of the paper, references to 'financial assets' mean 'financial assets subject to impairment.'

business activities. It is also important to note, however, that under both sets of proposals the provisions for loan losses continue to be based on the same information set, updated for changes in loss expectations.

The boards will continue to discuss developments as they move forward, and participate in each other's outreach during both boards' exposure periods. The comment periods will have some overlap and the boards will consider public comments on both approaches during redeliberations. The timing of the issuance of final requirements will depend on the nature and the extent of feedback received, but the boards expect to complete deliberations in 2013.

Hedge Accounting

The objective of the IASB's project is to improve hedge accounting by more closely aligning the accounting with a company's risk management activities, thereby improving financial reporting. As previously discussed, the Hedge Accounting phase of the Financial Instruments project is not a joint project. However, the FASB sought comments from its stakeholders on the IASB's Hedge Accounting Exposure Draft, and will consider these and the decisions reached during redeliberations in conjunction with feedback on its own proposals, when it recommences its hedge accounting deliberations.

Other projects

Leases

Lease obligations are widely considered to be a significant source of off balance sheet financing. The objective of the Leases project is to improve financial reporting by lessors and lessees, in particular by recognising leases on the balance sheet.

The boards have completed discussions on the Leases project and have agreed to re-expose the revised proposals for identical standards on lease accounting. The boards plan to publish exposure drafts in the second quarter of 2013 with a 120-day comment period. During the comment period, the boards will conduct additional outreach with users of financial statements and with entities that undertake lease activities. The boards plan to jointly redeliberate the proposals later this year. The timing of the issuance of the final requirements will depend on the nature and extent of the feedback received.

Revenue Recognition

The objective of this project is to improve financial reporting by creating identical standards on revenue recognition that clarify the principles that can be applied consistently across various transactions, industries and capital markets. The project applies to all contracts with customers (except leases, financial instruments and insurance contracts).

In December 2012 the boards completed the substantive redeliberations of the recognition and measurement principles in the 2011 Exposure Draft. The boards plan to redeliberate the

remaining topics, including the scope, disclosure, transition and effective date, in the first quarter of 2013 and issue final standards in mid-2013.

Insurance Contracts

The objective of this project is to eliminate inconsistencies and weaknesses in existing practice and to provide a single principles-based Standard to account for all insurance contracts. While the boards are working together on the Insurance Contracts project they have reached different decisions on several basic matters. For example, while both boards have agreed to measure the insurance liability using a current measure of the estimated cost to fulfil the obligation, the boards have reached different decisions on several aspects of the model, including the recognition of changes in estimate, the inclusion of a risk margin in the measurement of the liability and the treatment of acquisition costs. The boards finalised their joint discussions in January 2013.

The obstacles to finding a converged solution for the Insurance Contracts project may be difficult to overcome. In particular, the different decisions reached by the boards are a result of different starting points (IFRS currently does not include accounting requirements for insurance contracts so the IASB needs a final Standard urgently, whereas the FASB is proposing amendments to its long-standing insurance model).

Due to the importance of the project and in view of the extensive debate the IASB has undertaken over the years, the IASB will only seek feedback on five key matters which have significantly changed since the 2010 Exposure Draft. The IASB hopes that this approach will avoid further undue delays in finalising this much-needed Standard for insurance contracts. The IASB plans to publish this Exposure Draft in the first half of 2013.

The FASB plans to publish its first Exposure Draft in mid-2013.

Investment Entities

The Investment Entity project was, in the most part, jointly deliberated. However, the FASB is addressing the accounting for investment entities more broadly than the IASB did, as the latter's focus was solely on an exemption from consolidation. Consequently, the boards' final requirements will be similar but not identical. The IASB issued its final requirements in October 2012. The FASB plans to finalise its redeliberations and issue a final Standard in the first half of 2013.

Summary of the IASB proposed impairment model
prepared by the International Accounting Standards Board
11 February 2013

Background

The objective of the Impairment project is to improve the information provided about the credit quality of financial assets by accounting for expected losses in a timely manner.

To determine expected losses, all information that is available without undue cost and effort is used, including reasonable and supportable forecast information. The IASB has already exposed expected loss impairment proposals for comment. The information set and the use of expected values as a basis for calculations has not changed over the course of the project. To better understand the genesis of the IASB's current model it is helpful to look at those prior proposals.

Exposure Draft

The Exposure Draft *Financial Instruments: Amortised Cost and Impairment* (the ED) was published in November 2009. This model recognised that initial loss expectations are priced into financial assets—when an entity originates a higher-risk loan, it charges a higher margin to compensate it for those higher loss expectations. This was reflected in the ED by reducing the effective interest rate used to calculate interest revenue by the initial expected credit losses. The asset would always be measured at the present value of the (updated) expected cash flows, so any increase in loss expectations would be recognised immediately as a loss.

While the conceptual merits of this model were supported it was not pursued because of concerns about the costs of implementation. In particular there were concerns about the requirements to determine and track the credit adjusted effective interest rate and to distinguish initial loss expectations from changes in those expectations in open portfolios.

Supplementary Document

The Supplementary Document *Financial Instruments: Impairment* (the SD) was published in 2011. This document was published jointly by the IASB and the FASB following requests to both boards from our respective stakeholders to develop a converged expected loss model.

The SD separated (or decoupled) the measurement of expected losses from the interest calculation, so interest revenue was recognised at the contractual effective interest rate (ie unadjusted for expected losses) and the allowance balance was established separately. This addressed operational concerns that had been raised about the ED.

The timing of recognition of expected credit losses in the SD depended on whether assets were classified as being in the "good book" or the "bad book". Recognition of full lifetime expected losses was required when the asset became a problem asset, so that the focus was on <u>recovery</u> of the asset (the bad book). In the good book, it was proposed that an allowance balance should be recognised equal to the greater of (a) a time-proportionate amount of the lifetime expected losses (based on the weighted average age of the portfolio of assets) (the TPA) or (b) an amount equal to expected losses in the foreseeable future. The TPA was designed to provide an operational proxy for the ED.

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The main concern raised about the SD was the requirement to undertake dual calculations for assets in the good book – this was viewed as operationally burdensome and potentially confusing for users of financial statements. In addition, there was a strong geographical divide between US and non-US respondents on how to address this concern, with non-US respondents preferring to remove the foreseeable future calculation and US respondents preferring to remove the TPA. This led the boards to conclude that it would not be possible to reach a converged solution based on the SD.

Current proposed model

The current model, commonly referred to as the "three bucket approach"[1], was originally developed jointly with the FASB. The objective of the proposed model is to reflect deterioration (and improvements) in credit quality. The model would require expected losses to be recognised on all financial assets subject to impairment accounting. However, an allowance balance reflecting a portion of the lifetime expected losses would be recognised initially, with full lifetime expected losses being recognised only when an asset deteriorates and meets the lifetime criterion as described below. This is to reflect that if a loan is originated on market terms, a loss is not suffered economically so only a moderate allowance should be established to provide some offset to the contractual interest revenue in profit or loss. The objective of the lifetime criterion is to recognise full lifetime expected losses when an economic loss is suffered. Consequently, recognition of lifetime losses occurs at the point when credit quality deteriorates beyond the level that was originally anticipated and priced into the assets.

Full lifetime loss recognition would occur earlier under the three-bucket model than under the SD model because the three bucket model focuses on deterioration in credit quality whereas the SD focuses on proximity to default.

Following the FASB's decision to pursue a different impairment model (referred to as the Current Expected Credit Loss Model or CECL), the IASB undertook additional outreach with stakeholders about the three-bucket model. A majority of those involved in the outreach (including users of financial statements) agreed that it was appropriate to differentiate the allowances on assets that have deteriorated from those that have not. However, the IASB was asked to clarify when an asset is considered to have deteriorated to a point where life time losses should be recognised.

Recognition of expected losses under the three bucket model

The allowance for expected losses for an asset consists of either: (a) twelve months' expected losses or (b) lifetime expected losses depending on whether the asset meets the lifetime criterion[2].

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[1] On completion of developing the impairment model it was tentatively agreed that it was only necessary to distinguish between assets with a 12-month allowance balance and those with a lifetime expected loss balance. Thus, the impairment model is now essentially a "two-bucket" model. However, because of general familiarity with the "three-bucket" description and because a third stage of deterioration (ie incurred losses) results in a change in the way in which interest revenue is presented, we will continue to use the term "three-bucket" when discussing the IASB's current proposed impairment model.

[2] The model is different for assets impaired on initial recognition as described later in this summary.

**Summary of the IASB proposed impairment model
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11 February 2013**

Twelve months expected losses (informally referred to as "Bucket 1")
Twelve months' expected losses are all cash shortfalls expected over the life of the asset weighted by the probability of a loss event occurring in the next 12 months. These losses are **not** only the cash shortfalls over the next 12 months, nor does this approach capture losses on assets that are expected to actually default in the next 12 months—an asset that is actually expected to default in the next 12 months should have met the lifetime criterion so full lifetime expected losses should be recognised. The 12 month measure provides a proxy for adjustment to the contractual yield proposed in the original ED.

Lifetime expected losses
An allowance should be measured at the amount of lifetime expected losses if the asset meets specified criteria (the lifetime criteria). At its November 2012 meeting the IASB agreed on clarifications to the original lifetime criteria. Initially the boards had jointly agreed that lifetime losses should be recognised when there had been a "more than insignificant" deterioration in credit risk and it was "at least reasonably possible" that contractual cash flows would not be fully collected. Those criteria have now been clarified and simplified to a single criterion (the lifetime criterion). This criterion would require recognition of lifetime expected losses when there has been significant deterioration in credit quality since initial recognition (when considering the term of the asset and the original credit quality). For assets that are investment grade on origination the lifetime criterion would be considered satisfied if those assets fall below investment grade.

The IASB has received preliminary feedback that while judgement is still required to apply the lifetime criterion, the requirement is now more clearly articulated and more operational.

In order to assess when a significant deterioration in credit quality has occurred, a range of information can be used. The relevant information used to assess this deterioration will depend on facts and circumstances and what is available without undue cost and effort. The information can include an increase in probabilities of default, changes in internal or external risk ratings, changes in market prices for the issuer's credit, and whether the entity would reprice the asset, because of a deterioration in credit quality, if the asset were to be reoriginated. The focus is on deterioration in credit quality so an actual loss event need not have occurred for lifetime losses to be recognised; instead, the deterioration in credit quality occurs when macro-economic or issuer specific factors have caused the entity to reassess the credit quality of the asset.

The information used should be as forward-looking as possible, however, as an operational concession, if the best information that is available without undue cost or effort is delinquency information, an entity may use that information to assess the criterion—there will be a rebuttable presumption that lifetime losses should be recognised when an asset is 30 days past due. However, where more forward looking information is available, deterioration should be identified before delinquencies arise.

Summary of the IASB proposed impairment model
prepared by the International Accounting Standards Board
11 February 2013

Assets that are credit-impaired on initial recognition

If an asset is impaired on initial recognition, a different approach applies. An entity shall (a) include lifetime expected losses in determining the effective interest rate used to determine interest revenue; and (b) recognise all subsequent changes in lifetime expected losses in profit or loss.[3] The IASB believes that by adjusting the interest on such assets, better information is provided to investors.
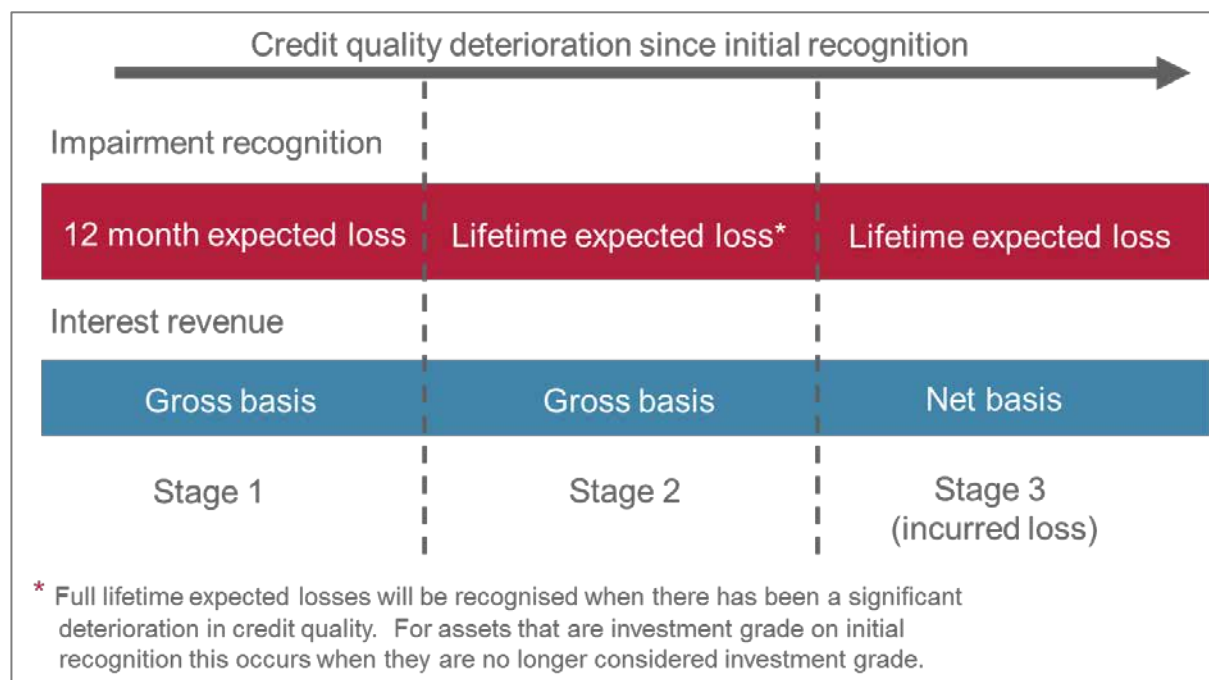
Other instruments

The three-bucket model applies to all financial assets measured at amortised cost or fair value through other comprehensive income. It also applies to off balance sheet items such as loan commitments and financial guarantees. However, the three-bucket model includes a simplified approach for trade receivables and lease receivables. For these assets, the allowance balance may always be determined based on lifetime expected losses, so preparers need not assess the need to change the allowance balance from the 12-month to the lifetime measurement.[4]

Interest revenue

Interest revenue is presented "gross" of expected losses[5] until there is objective evidence of impairment, when interest is presented "net"[6] in profit or loss.

The three stages of the model are best illustrated with the following graph:

Credit quality deterioration since initial recognition

Impairment recognition		
12 month expected loss	Lifetime expected loss*	Lifetime expected loss
Interest revenue		
Gross basis	Gross basis	Net basis
Stage 1	Stage 2	Stage 3 (incurred loss)

* Full lifetime expected losses will be recognised when there has been a significant deterioration in credit quality. For assets that are investment grade on initial recognition this occurs when they are no longer considered investment grade.

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[3] Note this is a requirement in IAS 39 paragraph AG 5 today and hence would not affect current practice.

[4] The FASB's CECL model also includes this simplification.

[5] So interest is calculated on the carrying amount before allowances for expected losses.

[6] So interest is calculated on the carrying amount net of allowances for expected losses.

Summary of the IASB proposed impairment model
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Comparison of the IASB and FASB proposals

The following table sets out the key similarities and differences between the boards' proposed impairment models. The differences are further discussed below.

Similarities	Differences
• Both models are expected loss based rather than incurred loss based • Expected values are used to measure expected losses, not most likely outcomes • The time value of money is considered in both models • The same information set is used to determine the expected losses • If the lifetime expected loss criterion is met, the allowances are the same • Interest revenue is calculated on the gross carrying amount for non-credit impaired assets • Both models require a credit-adjusted effective interest rate for purchased credit-impaired assets • Both models will provide enhanced disclosures	• If the assets do not meet the lifetime criterion the allowance for credit losses will be based on 12-months' expected losses under the three bucket model and lifetime expected losses under the CECL model.

Key results of the differences in the boards' proposals

Before the lifetime criterion in the three-bucket model has been satisfied, the three-bucket model would require an allowance to be recognised based on the 12-month measurement, whereas the CECL model would require a lifetime allowance to be recognised. Consequently, the timing of the recognition of lifetime losses will differ. However, for short-term high quality assets there would be little difference in these measurements. For example, holding all else equal, the allowance for a 2-year AA loan of €100,000 assuming a 50% loss given default (LGD) even prior to meeting the lifetime criterion would be essentially the same under the two models[7].

The situation in which the application of the models would provide the most pronounced differences before the lifetime criterion is met would be for an asset that is below investment grade on origination and for long-term assets (even if they are investment grade).

One European bank provided the IASB staff with an example of the difference between how they would apply the two models for a 30-year residential mortgage loan for €500,000. Considering expectations for this instrument of this credit quality and term, the bank estimated that there is a 2% probability of default, or PD, in the next 12 months for this instrument. The loss given default, or LGD, was estimated to be 20%. Therefore, the 12-month allowance for expected losses, or EL, would be €2,000[8] for this loan (.02*.20*€500,000) and the net carrying amount in the statement of financial position would be

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[7] The 12-month allowance would be €10 using a 12-month probability of default (PD) of .02% and the lifetime allowance would be €35 using a lifetime PD of .07%. The PDs are per Standard and Poor's *2011 Annual Global Corporate Default Study and Rating Transitions*.

[8] For the purposes of simplicity this does not include the effects of discounting.

Summary of the IASB proposed impairment model
prepared by the International Accounting Standards Board
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€498,000 on "day one". For the lifetime expected loss, the bank estimated the cumulative lifetime PD to be 24% with an LGD of 20%. Consequently, the allowance for lifetime expected losses on "day one" for this loan would be €24,000[9] and the net carrying amount would be €476,000.

The lifetime expected loss on recognition of the above loan is 12 times the size of the loss using a 12-month probability of default. This is a significant difference, which is driven by the duration of the asset. This is an example of a core asset type of high quality—a residential mortgage with solid security. The lifetime expected loss equates on origination to nearly 5 per cent of the notional amount of the loan. Being priced on market terms, the fair value of the loan is €500,000. To recognise this all up front, before recognising the (high) margin over the life of the asset (across the portfolio), would cause the high quality asset to be recognised at 95 per cent of its value. The IASB is concerned that this distorts the carrying amount of the asset on the balance sheet.

This difference is important considering that nearly 20 per cent of new global bond issues through October 2012 were speculative-grade on origination (ie "BB+" and lower)[10]. Recording full lifetime expected losses on initial recognition understates the value of these assets on the balance sheet and could adversely affect lending to small and medium-sized companies and also long-term lending. An entity could boost profits by reducing lending to entities with higher–credit risks, reducing the duration of loans or simply reducing lending—this could be attractive in a downturn. The "day one" effect may also impose a large hurdle on new market entrants, because the cost of entry into the loan market becomes prohibitively high due to the large "day one" loss.

The IASB's approach also has a "day one" impact as a result of trying to find an operational proxy for the ED model and thus includes the 12-month measure. However, as illustrated above, the allowance on "day one" is significantly smaller in most cases.

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[9] For the purposes of simplicity this does not include the effects of discounting.

[10] Per Standard and Poor's: *Credit Trends: 2012 Global Corporate New Bond Issuance Through October Tops The Full-Year 2011 Total* published 9 November 2012

International Financial Reporting Standards

Proposed Impairment Approach:
Three Bucket Model

11 February 2013

The views expressed in this presentation are those of the presenter, not necessarily those of the IASB or IFRS Foundation.

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Impairment: Objective of model

2

Guiding principle: Reflect general pattern of deterioration and improvement of credit quality of financial assets

- Expected loss model–more forward looking information
- Responsive to changes in information that impact credit expectations
- Information about deterioration: deterioration in credit quality leads to recognition of lifetime losses
- Distinction between assets that have deteriorated to an extent an economic loss has been suffered and those that have not

November 2012 FSB Steering Committee

IFRS

Key messages from outreach

3

- Support for a model that distinguishes assets that have deteriorated from those that have not

- But need to clarify criteria for when lifetime loss recognition is required

- Some asked the IASB to reconsider earlier models if unable to converge on the three bucket model

November 2012 FSB Steering Committee

IFRS

Criterion for lifetime expected losses – three bucket model

4

- Full lifetime expected losses will be recognised when there has been a significant deterioration in credit quality
  - for assets that are investment grade on initial recognition this occurs when they are no longer considered investment grade
  - clarification is in response to feedback received

- Guidance on how to assess the criterion will include consideration of:
  - probabilities of default
  - pricing of instruments
  - delinquencies
  - internal or external credit grades

November 2012 FSB Steering Committee

IFRS

Comparison of the IASB and FASB proposals

5

Similarities
• Information that is used to estimate expected losses
• Measurement reflects multiple possible outcomes (expected value) and time value of money
• Models apply to the same assets
• Interest revenue is decoupled for assets that are not purchased credit-impaired
• One impairment model based on credit losses (ie not market prices)
• Allowance balances: ➢ Similar for short-term high quality assets ➢ Similar for assets that have deteriorated significantly (lifetime losses)

Differences
• IASB model only requires recognition of a portion of the lifetime expected losses prior to significant deterioration
• Allowance balances prior to deterioration are significantly different for: ➢ Long-term assets even if investment grade ➢ Assets below investment grade

November 2012 FSB Steering Committee

IFRS

Concerns with CECL approach

6

- Reliability of lifetime measures on initial recognition
- Size of lifetime losses can significantly distort balance sheet amounts
- Timing of recognition of full lifetime expected losses:
  - ➢ greater risk of earnings management when recognised on "day one"
  - ➢ incentives for limiting lending when earnings are under pressure
  - ➢ potential for adverse effects on lending practices: small and medium sized companies, long term lending
  - ➢ high costs for new entrants to the loan market

November 2012 FSB Steering Committee

IFRS

Next steps

- Exposure draft to be published in Q1 2013
- 120-day comment period
- Communications throughout the process with FASB on the feedback received on their proposals
- Effective date:
  - ➢ depends on need for changes in systems
  - ➢ interaction with other projects
- We will ask for information in the ED regarding lead times needed to provide a basis for deliberations

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Questions or comments?

Expressions of individual views by members of the IASB and its staff are encouraged.

The views expressed in this presentation are those of the presenter. Official positions of the IASB on accounting matters are determined only after extensive due process and deliberation.

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February 11, 2013

Current Expected Credit Loss Model (CECL)

Overview of the FASB Model

Consistent with joint decisions--

- Management's estimate based on information about:
  - Past events
  - Current conditions
  - Reasonable and supportable forecasts about the future
- Estimate of expected credit losses should consider both:
  - an outcome in which a credit loss results; and
  - an outcome in which no credit loss results
  - NOT the most likely outcome (e.g., 80% likely no loss, therefore, no allowance)
  - *Cumulative loss rates and PD metrics already incorporate this notion*
- Estimate of expected credit losses should consider the time value of money (which is implicit in several approaches)

FASB Model – In practice

- Every reporting period, **expected credit losses** would be re-estimated; favorable and unfavorable changes would be reported in earnings

- A current estimate of expected credit losses would be made, based on the current **risk ratings** of the assets, **historical loss experience** for assets with similar risk ratings and remaining lives, **adjusted for changes** in current circumstances, and reasonable and supportable expectations about the future

- The allowance typically does not relate to any specific asset; it often relates to **pools** of assets with similar credit risk and remaining lives

- The effect in any period will depend on **changes** in the **volume** of loans originated, maturing, and the **extent of deterioration** or recovery. In a stable pool, the effect primarily relates to *changes* in expectations about credit losses because the amount of loss relating to new loans is offset by the pay-off of maturing loans.

Example of a Loss Rate Approach

- National Bank A has a portfolio of five-year commercial mortgage loans

    - Every reporting period, it evaluates the current credit risk of each loan using its internal review procedures and grading system

    - It assigns each risk category a loss rate, that reflects its current estimate of the likelihood and magnitude of loss for loans in that risk category

    - The loss rate is based on experience over the lives of loans with similar risk characteristics, adjusted changes in current conditions and reasonable and supportable forecasts that differ from historical experience

Example of a Loss Rate Approach (cont.)   5

- National Bank A calculates the following estimate based on its loss rate approach:

($ in 000's)				
Risk rating category	Pass Category 2	Pass Category 4	Special Mention	Total
Expected loss rates	0.50%	3.00%	8.00%	1.60%*
Ending balance	27,500	10,000	2,500	40,000
Expected credit loss estimate	138	300	200	638
* The 1.60% weighted average loss rate is calculated as the total expected credit loss estimate divided by the ending balance.				

- Portfolio is disaggregated using internal loan review and grading systems
- Loss rates are commensurate with current risk status of loans
- Performing loans attract less of an allowance than nonperforming loans
- No "cliff effect"; allowance is adjusted for changes in credit quality every period

FASB (CECL) model compared with the three-bucket model   6

- Key difference
  - CECL model uses **single measurement objective**, whereas three-bucket model uses **dual** measurement objective
    - CECL model is a model based on the "absolute" level of credit risk, as opposed to a model based on the "relative" change in credit risk (which requires a threshold or trigger)
    - CECL model does not have a "transfer notion"; estimates are based on all available information every period; never limited to next 12 months
- This was the primary source of concern and confusion among US stakeholders

The "Day 1" Issue

- Some believe that the FASB model recognizes losses prematurely and in excessive amounts
  - When looked at as a pool, there is an expected loss that is not attributable to specific assets
  - Present in current GAAP, 3-bucket, and FASB model; it's a matter of degree and timing
  - Clearly a **transition** issue; regulators can phase-in (as was done for SPEs); effect would be moderate in ongoing, stable businesses
- FASB rationale
  - Model is based on expected losses that reflects consideration of all available information
  - This is a timing issue; if losses are expected to occur, should not wait for triggering event
  - The amount is based on the current status of the loans, NOT the worst-case loss upon default
- FASB concern about 12-month, "proportionate approach" for bucket 1
  - Most credit losses emerge early in life; waiting for triggering or confirming event defers timely loss recognition
  - Losses are foreseeable beyond 12 months; allowance does not reflect all expected losses
  - Initially obscures riskier lending practices, followed by a "catch-up" when the trigger (confirming event) is hit

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CECL Model – Debt Securities and Financial Assets Measured at FV-OCI

- Securities and non-securities follow the same approach

- However, as a **practical expedient**, an entity may elect not to recognize expected credit losses for financial assets classified at FV-OCI when both of the following conditions are met:
  - FV of the financial asset is greater than the amortized cost basis
  - Expected credit losses on the financial asset are insignificant

- Practical expedient for **high-quality assets**; cost-benefit consideration

Purchased Credit Impaired (PCI) Assets

- Common issue for **business combinations** and portfolio transfers; current GAAP is complex and confusing

- FASB proposal follows same approach to estimating expected credit losses as originated and non-PCI assets
  - The allowance would be based on management's current estimate of the contractual cash flows that the entity does not expect to collect
  - Changes in credit impairment allowance (favorable or unfavorable) recognized immediately as bad debt expense

- **Initial** estimate of expected credit losses is recognized as an adjustment to the cost basis of the asset (an allowance) and would **not** be recognized as interest income

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CECL Model – The Result

- For investors:
  - Balance sheet reflects management's current estimate of expected credit losses at the reporting date
    - Allowance can be **easily understood** since it is based on a single measurement objective
  - Income statement reflects **changes** in expected credit losses during the period
    - No "cliff effect" resulting from a change in measurement objective for the credit impairment allowance
  - Interest income measured **separately** from credit losses; however, **accrual ceases** when collection is not probable
    - Consistent with investor's suggestions following the May 2010 Exposure Draft
  - **Disclosures** provide insight into the credit quality of financial assets at each reporting date and **illustrate credit deterioration** occurring during the reporting period

CECL Model – The Result (continued)

- For preparers:
  - A model that **leverages existing** internal credit risk management **tools and systems**; however, the **inputs** to the measure **will change**
  - A consistent measurement approach throughout the portfolio with **no barriers to recognition**
  - An approach for PCI assets that is
    - less complex and costly to implement
    - easier to explain to investors

Next Steps

- Issue Exposure Draft in December
- Invite comments on IASB's proposal and highlight remaining differences
- Try to align comment periods so we are poised to consider global feedback concurrently