



Project	Financial Instruments – Recognition and Measurement
Topic	Impairment: transition – further alternative approaches, effective date and comparative information

Introduction

Background

1. The Board discussed transition to the expected cash flow (ECF) approach at its 22 September 2009 meeting. The Board
 - (a) tentatively decided not to use either full retrospective or full prospective application, but
 - (b) asked the staff to explore further an alternative transition approach for financial instruments that were recognised before the date of transition. This approach would involve determining on transition a new effective interest rate (EIR) on the basis of the expected cash flows over the remaining life of the financial instrument that would be subject to a floor (the risk free interest rate) and a ceiling/cap (the contractual interest rate). This approach is referred to in this paper as the ‘**EIR collar approach**’.

Purpose of this paper

2. This paper sets out the mechanics of the modified EIR reset approach, its pros and cons, and the related staff recommendations and questions to the Board. This paper does not address any transition related disclosures.

This paper has been prepared by the technical staff of the IASCF for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in *IASB Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

IASB Staff paper

3. As this paper addresses the transition regarding the ECF approach it solely pertains to financial instruments that will be in the scope of the new financial instruments standard and will be measured at amortised cost. Thus, all references in this document to ‘asset(s)’ shall be taken to refer to **only** those financial instruments. In addition, this paper solely addresses assets with an initial recognition date before the date of transition to the ECF approach. Only these would be affected by the EIR collar approach whereas assets that are initially recognised on a later date apply the ECF approach (without modification).

4. Before moving onto the rest of this paper, the staff reminds the Board that:
 - (a) the Board does not have a good track record in developing complex transition requirements; and
 - (b) transition was noted by many respondents to the Request for Information as a possible significant source of operational complexity and cost.

Mechanism of the effective interest method and implications for transition

5. Before turning to transition using the EIR collar approach it is useful to recall the basics of the effective interest method. The EIR is a parameter determined by iteration rather than an observable parameter or determinable by a direct analytical method. The implications are that you can determine
 - (a) either the EIR if the carrying amount (starting point) and the future cash flows are known; **or**
 - (b) the carrying amount if the EIR and the future cash flows are known.

IASB Staff paper

6. When trying to determine the EIR and the carrying amount simultaneously an infinite number of combinations exist (ie neither variable is definite). That is to say you cannot change both at the same time, and you need to fix one of them.

7. From a purely ‘mechanical’ perspective the implications for amortised cost transition approaches are as follows:
 - (a) any approach that does not involve going back with the calculation before the date of transition can
 - (i) either reset the EIR, which means carrying over the carrying amount on transition, **or**
 - (ii) change the carrying amount, which means carrying over the EIR.
 - (b) (in contrast) any approach that involves going back with the calculation before the date of transition can change both the EIR and the carrying amount that would otherwise arise *on transition* under the previous accounting method.¹ Retrospective application would be one example of an approach that goes back in time (in this case to initial recognition of the asset).

¹ The mutually exclusive alternatives set out under paragraph 7(a) apply at the date when the respective variable is determined.

IASB Staff paper

The EIR collar approach***Overview of the approach****Basic design*

8. As set out earlier in this paper,² the Board asked the staff to explore a transition approach that resets the EIR using a collar that has the following boundaries (EIR collar approach):
 - (a) the risk free interest rate as a floor; and
 - (b) the contractual interest rate as a cap (ceiling).

9. The floor is necessary to avoid nonsensical outcomes for the (reset) EIR. Economically, a discount rate for an asset cannot be lower than the risk free interest rate because otherwise the resulting carrying amount would not appropriately reflect the time value of money, thus failing a basic requirement of any present value. Without this boundary the EIR could even become negative, for example in case of expected losses that are not yet incurred on transition.

10. In the staff's view the floor must be the *original* risk free interest rate, ie that from the date of initial recognition of the asset. Using the risk free interest rate on the date of transition would mean that market interest rate changes between initial recognition and transition result in a partial remeasurement to fair value on transition, which is inconsistent with using an expected cash flow impairment methodology for financial assets measured at amortised cost.

11. In the staff's view using the contractual rate as the ceiling has the following problems:

² See paragraph 1(b).

IASB Staff paper

- (a) If ‘contractual’ was taken to be the coupon rate then premiums or discounts would cause distortions:
 - (i) any discount means the contractual rate is not a ‘natural’ ceiling (the EIR would be higher); and
 - (ii) any premium means the EIR would be lower than the ceiling implied by the contractual rate.
- (b) Even if discounts are taken into account for the contractual rate it is a ‘natural’ ceiling for assets *only* if the asset is not prepayable.³ For a prepayable asset with a discount the EIR would exceed the contractual rate unless the estimate was there are no prepayments at all.
- (c) Any transaction costs result in an original EIR that would be lower than the contractual rate. Thus, using the contractual rate is tantamount to not allocating transaction costs but understating the asset on transition and having overstated interest revenue after transition.

12. The staff believes that using the original EIR determined under the incurred loss model as the ceiling is more appropriate. This is because:

- (a) using the original EIR determined under the incurred loss model avoids the problems discussed above; and
- (b) the expected EIR under the ECF approach would not exceed the EIR under the incurred loss model for any asset (it would be equal for a risk free asset but lower for all other assets).

³ Similarly, an extension option in conjunction with a premium means that the contractual rate if it took into account the premium would not be a ‘natural’ ceiling unless the estimate was that the term would not be extended.

IASB Staff paper

Alternative reference dates for EIR reset

13. As set out earlier in this paper,⁴ the transition approach can use the carrying amount at different *reference dates* for resetting the EIR:⁵
- (a) the date of transition; or
 - (b) the date of initial recognition of each asset (ie go back to the *initial* carrying amount of the asset).
14. If the date of initial recognition of each asset were used (ie alternative (b) above) then the input data for the cash flows from that date to the transition date would have to be the *actual* historic cash flows during that period in order to avoid that the use of hindsight allows arbitrary assumptions.

Implications of the EIR collar approach*Conceptual implications*

15. An EIR collar approach would involve two different types of transition adjustments that would apply depending on the scenario on transition:
- (a) **Scenario A:** an EIR reset if the reset EIR would be within the collar, which means the asset's carrying amount (amortised cost) is carried over from the incurred loss model; and
 - (b) **Scenario B:** an adjustment of the amortised cost carrying amount if the reset EIR would be outside the collar, using the floor or cap interest rate as the EIR (discount rate).

⁴ See paragraph 7.

⁵ The staff believes that only the two ends of the spectrum but not the dates in between are reasonable candidates for the reference date because the dates in between would be arbitrary.

IASB Staff paper

16. Scenario A results in smoothing the effect of switching the credit loss estimate from an incurred to an expected basis. The impact depends on the reference date used for transition:
- (a) **Date of transition:** the smoothing results from resetting the EIR such that the cash flows determined under the ECF approach result in a present value that is equal to the carrying amount determined under the incurred loss model. Thus, the change in the credit loss estimate does not have an immediate effect (no decrease in the carrying amount and thus no additional provision). For example, if the credit loss estimates under the ECF approach are higher than those under the incurred model, the carrying amount will only be reduced over time as the reset EIR is lower than the previous EIR (and the contractual rate) with the rate differential 'building up a reserve'.
 - (b) **Date of initial recognition:** the smoothing would result from using the expected loss on the date of transition rather than on initial recognition as the input for the EIR calculation. For example, if the credit loss estimates are higher on transition than they would have been on initial recognition of the asset the resulting EIR is lower than what it would have been if it had been determined on initial recognition. Thus, the new carrying amount determined on transition is higher than what it would have been had the ECF approach been applied retrospectively.
17. In Scenario B the EIR is not determined by iteration but instead a known interest rate is used. Using this given parameter as the discount rate means that at no time during the life of the asset (before maturity) would the carrying amount constitute an amount that represents amortised cost. This is because the starting point implied by the calculation would not equate to the fair value on initial recognition (plus transaction costs). This is the inevitable consequence of replacing the iterative calculation with a given parameter.

IASB Staff paper

18. In Scenario B the EIR collar approach would also often have a smoothing effect. In all cases in which the EIR under the ECF approach would have been higher than the risk free interest rate the present value (ie the carrying amount) that results from discounting using the floor rate of the collar is higher than the carrying amount that would have resulted had the ECF approach been applied retrospectively.

Operational implications

19. In the staff's view the EIR collar approach would also have some operational implications:
- (a) If the date of initial recognition of each asset was chosen as the reference date for resetting the EIR there are specific operational implications:
 - (i) Sourcing the data about the historical cash flows could be difficult for variable rate assets (in particular in combination with cap, floor or collar features, or variable margins).
 - (ii) Initial transaction cost amounts would have to be available to avoid that they are excluded from the EIR when it is reset. This might be particularly difficult for groups of assets that use 'profiling' of run-off patterns. A similar issue relates to adjustments for prepayment estimates.
 - (b) The application on a group basis (eg portfolio level) creates the issue of how to make the collar operational for groups. Would the collar rates be applied on an individual assets basis to avoid a netting effect of the assets within the portfolio or could rates directly determined on a portfolio level be used?
 - (c) The risk free rate for variable interest rates is not always straightforward as benchmark variable interest rates are typically above risk free (eg LIBOR). Risk free variable interest rates for the past

IASB Staff paper

would often be data that needed to be constructed for transition purposes (rather being readily available in existing data storage systems).

Staff recommendation regarding the EIR collar approach

20. The staff believes that:
- (a) The EIR collar approach has significant conceptual weaknesses. If the date of transition is used as the reference date the smoothing effect is of particular concern.
 - (b) There is a high risk of significant operational challenges that would arise under this transition approach. These would be even greater if the date of initial recognition of each asset was chosen as the reference date.
21. While the EIR collar approach avoids the systematic effect on equity (reduction) that results from a combination of using the EIR determined under IAS 39 in combination with the cash flow estimate under the ECF approach (the ‘customised transition approach’⁶) it results in high complexity together with conceptual and operational weaknesses. The staff believes that overall the EIR collar approach is not a suitable transition approach and, thus, recommends that it not be pursued further. The next section of this paper sets out another alternative for transition (an EIR margin adjustment approach) that the Board should consider instead.

⁶ See agenda paper 4 of the 22 September 2009 IASB meeting (paragraphs 16-24).

IASB Staff paper

Question 1 – EIR collar approach

Does the Board agree with the staff recommendation not to pursue the EIR collar approach further?

If the Board does not agree with the staff recommendation, what does the Board prefer, and why?

The EIR margin adjustment approach

22. An alternative transition approach is an **EIR margin adjustment approach**, which works as follows:
- (a) the *objective* is to determine an adjustment to the EIR under IAS 39 that results in an adjusted EIR that approximates the EIR that would have been determined under the ECF approach (EIR transition adjustment).
 - (b) from this objective the following *principle* can be derived: in determining the EIR transition adjustment entities shall make maximum use of historical data and supplement that as needed with information for similar products for which the expected EIR under the ECF approach has been determined, ie products originated or acquired near transition (new products).
 - (c) this principle can be applied in different ways, for example:
 - (i) by using ratio analysis to infer the EIR transition adjustment using information for similar new products (Appendix A provides an illustrative example of ratio analysis);
 - (ii) carrying back the expected margin on similar new products as the EIR transition adjustment; this approach would require to ensure that the adjusted EIR is not below

IASB Staff paper

the original risk free interest rate (which is a natural floor)⁷.

Staff recommendation regarding the EIR margin adjustment approach

23. The staff believes that on the one hand the EIR margin adjustment approach likely achieves the best outcome regarding the information for assets that were initially recognised before transition, ie results in information that most closely approximates the outcome of full retrospective application.

24. On the other hand, the staff believes that compared to the ‘customised transition approach’⁸ the EIR margin adjustment approach involves more significant operational challenges and, thus, a greater transition effort by entities (which affects cost and lead time).

25. The staff recommends that the Board either choose the ‘customised transition approach’ or the EIR margin adjustment approach. Given the trade-off between the information enhancement versus the increased operational challenges and costs the staff believes there is no obvious answer but that Board members need to use their own judgement regarding the cost-benefit assessment. However, the staff recommends that if the Board chooses the EIR margin adjustment approach the Expert Advisory Panel the Board decided to set up should be asked to look into the operational aspects of this transition approach.

⁷ See paragraphs 9-10.

⁸ See agenda paper 4 of the 22 September 2009 IASB meeting (paragraphs 16-24).

IASB Staff paper

Question 2 – customised transition approach versus EIR margin adjustment approach

Does the Board want to use the EIR margin adjustment approach for transition?

If not, does the Board want to use the 'customised transition approach'?

If the Board does not want to use either of the above approaches, what does the Board prefer, and why?

Effective date and comparative information

26. Another Board decision the staff needs for the exposure draft (ED) is the proposed effective date and comparative information.
27. As set out in the analysis of responses to the Request for Information on the feasibility of the ECF approach, most of the respondents who quantified the required lead time came with estimates in a range of 2 to 3 years *from the issue of a final standard*. Any final standard will not be ready before 2010. Thus, the staff believes that for the purposes of the ED the Board could choose to:
- (a) propose an effective date of annual periods starting on or after 1 January 2014 (or a later date but not earlier); or
 - (b) indicate in the ED that the Board would set an effective date that allows no less than 3 years lead time from the date of issue of a final standard.
28. If a lead time of 3 years is allowed then the question arises if restatement of comparative information would be required. For entities that have only one year of comparative information restating comparatives in effect reduces the lead time to 2 years. For entities with more comparative periods the lead time would be reduced even further. While in some circumstances carrying back the

IASB Staff paper

carrying amount determined for the beginning of the reporting period to the opening balance sheet of the comparative period might be rather straight forward it will not be for many other circumstances (eg variable rate instruments, impaired instruments, assets assessed on a portfolio basis). Even more importantly, if restatement of the comparative information is required entities need to have progressed their transition process by the beginning of the earliest comparative period such that the cash flow estimates under the ECF approach can be made (otherwise, the issue of hindsight would affect the comparative information).

29. The staff thinks that early application should be allowed although extensive use of that option in the financial sector is not expected. However, outside the financial sector early application might be more realistically possible and the staff sees no reason why the improved impairment model should not be made available earlier.

Staff recommendation for effective date and comparative information

30. In the light of the above discussion the staff recommends:
- (a) proposing in the ED that the effective date would allow no less than 3 years lead time from the date of issue of a final standard;
 - (b) that the ED proposes that comparative information does not have to be restated.; and
 - (c) allowing early adoption.

IASB Staff paper

Question 3 – effective date and comparative information

Does the Board agree with the staff recommendation:

- (i) to propose in the ED that the effective date would allow no less than 3 years lead time from the date of issue of a final standard?
- (ii) providing relief from restatement of comparative information?
- (iii) allowing early adoption?

If the Board does not agree with the staff recommendation, what does the Board prefer, and why?

IASB Staff paper

Appendix A

- A1. The table below illustrates the application of ratio analysis in order to infer the margin adjustment for expected credit losses under the ECF approach for assets that were initially recognised before transition.
- A2. The example works as follows:
- (a) The example analyses two vintages of the same product (Product A), one with initial recognition of the asset on transition (201Y) and one with initial recognition before the date of transition (200X) that was originally accounted for under IAS 39.
 - (b) For the 201Y vintage the breakdown of the margin between the contractually based EIR (as it is calculated under IAS 39) and the risk free interest rate (overall margin) is known. The two components are:
 - (i) the loss margin (effect of adjusting the EIR determined under IAS 39 for expected losses under the ECF approach); and
 - (ii) the residual margin, which is the remainder.
 - (c) In contrast, for the 200X vintage only the overall margin is known. However, its breakdown into the loss margin and the residual margin is not known as it was not necessary to be determined for applying IAS 39.
 - (d) The breakdown of the 201Y vintage into the loss margin and the residual margin is used to determine their ratios compared to the overall margin and then applied to the overall margin of the 200X vintage.

IASB Staff paper

Example of ratio analysis

Product A

Issue date

	201Y			200X	
	[A]	[B]	[C]	[D]	[E]
	Rates	Differentials	Ratios	Rates	<u>Implied</u> Differentials ²
EIR (IAS 39)	10%	4%	2/3	8%	2%
Loss margin	6%			6%	? ¹
EIR (ECF)	6%	2%	1/3		
Residual margin	4%			4%	5%
Risk free rate	4%	<u>6%</u>			

Footnotes:

1 The EIR under the ECF approach is unknown for assets with initial recognition before application of the ECF approach.

2 The implied differentials are calculated by applying the ratios in column [C] to the overall margin between the EIR determined under IAS 39 and the risk free rate (8%-5%=3%)