
Project	Financial Instruments: Replacement of IAS 39
Topic	Amortised Cost and Impairment – The Impairment Approach

Introduction

Purpose of this paper

1. This paper discusses the overall impairment approach. Specifically, the top part of the diagram set out in agenda paper 4. This paper focuses on the variation of approaches by different outlook periods. This perspective applies equally to portfolios of assets and individual assets. The implications of using cash flow or credit loss estimates determined on a probability-weighted basis or alternative bases will be discussed in a future paper.
2. This paper provides an analysis on the proposed impairment approach as set out in Exposure Draft *Financial Instruments: Amortised Cost and Impairment* (the ED) and other alternative approaches as suggested by some respondents to the ED and constituents from outreach activities. This paper does not ask for a decision. The Board will be asked in a later meeting how it wants to proceed.

The impairment approach

Expected loss and other alternative approaches

3. Many respondents support an impairment approach based on expected losses. A few respondents on the other hand suggest maintaining the current incurred loss impairment approach in IAS 39 *Financial Instruments: Recognition and*

This paper has been prepared by the technical staff of the IFRS Foundation 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 IFRS Interpretations Committee 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.

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Measurement. Others also suggest that in an expected loss approach, a minimum threshold should be applied for recognition of impairment losses.

4. An expected loss approach takes the view that the credit loss expectation – including the initial expectation – is a characteristic of the portfolio rather than looking at whether future defaults are ‘inherent’ in a portfolio. Future default expectations are implicitly or explicitly reflected in the pricing of the financial asset and do not depend on whether a credit loss is inherent in a portfolio. The expected loss approach links the profitability of the portfolio to *expected* credit losses. It views credit losses as an integral part of the lending decision (including pricing).
5. Lenders expect some credit losses from their lending activities already when making a lending decision. The contractual rate charged could be broken into different components reflecting:
 - (a) time value of money (‘risk-free rate’);
 - (b) compensation for expected credit losses at the outset;
 - (c) compensation for accepting risk (eg unexpected credit loss, liquidity risk etc); and
 - (d) a profit margin.

Expectation of credit losses ((b) above) forms a component of the contractual interest rate. Different expectations about credit losses are reflected in different contractual interest rates.

6. The initial carrying amount implicitly includes a deduction for expected losses¹. Consistent with initial measurement, the expected loss approach records the financial asset subsequently based on a return that reflects a deduction for

¹ At inception, the carrying amount of a financial asset can be regarded as the *contractual* cash flows, discounted at the contractual interest rate for which the contractual interest rate includes a return to cover expected credit losses. Or alternatively (which leads to the same answer) the initial carrying amount equals the *expected* cash flows discounted at the expected effective interest rate that is adjusted for the effect of expected credit losses [ie the risk free rate plus a risk premium plus a profit margin].

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initially expected losses (instead of the current IAS 39 model, which does not deduct those expected losses from the return).

7. Most respondents to the ED agree that an expected loss approach better reflects the economics of a lending transaction and how financial institutions manage credit risk.
8. The incurred loss approach on the other hand views credit losses as caused by loss events, and *until* a loss event occurs there is no loss inherent in a financial asset or portfolio. The incurred loss approach in IAS 39 has been criticised for many reasons. Some of these reasons are set out in the ED's Basis for Conclusions².
9. The incurred loss approach is internally inconsistent with the initial measurement of a financial asset as expected losses are implicit in the initial measurement of the asset. The subsequent accounting under the incurred loss approach ignores the expected loss until a loss event has occurred.
10. Credit losses occur because of a chain of events. It is rarely, if ever, possible to pick out one of those events and say that the loss occurred at that time. However, that is the premise under the incurred loss approach. Thus, any attempt to distinguish between losses that have already occurred and future losses will often be arbitrary. This has been reflected in practice where there is significant diversity and many application problems. This also became apparent during the Expert Advisory Panel (EAP) discussions. Entities have used different loss events or have assessed the same loss event differently when determining whether to record impairment losses.
11. A few respondents suggest that diversity in application of the incurred loss approach can be addressed by increased and/or improved application guidance. However, the staff notes that any additional application guidance for the notion of incurred loss would likely be arbitrary and re-create today's application

² Paragraph BC11 of Basis for Conclusions on Exposure Draft *Financial Instruments: Amortised Cost and Impairment*.

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problems in a different form. In particular the application problems regarding incurred but not reported (IBNR) credit losses demonstrate that it is impossible to distinguish an incurred loss and a future loss because it is not possible to say *when* the specific loss event occurred. Depending on the indicator used, a credit loss that is not yet incurred on the basis of one indicator can be incurred on the basis of another, more leading indicator.

12. A few respondents suggest that a threshold should be introduced as a minimum for when to consider expected losses (eg ‘more-likely-than-not’ that the entity will incur future losses on the instrument). While they note that such a threshold may only be useful for evaluating single instruments (as opposed to a portfolio), they argue that an introduction of a recognition threshold for impairment would reduce the burden and limit the recognition of impairment to cases where a minimum threshold is breached. In the staff’s view the introduction of any threshold to recognising credit losses (whether on a single instrument or portfolio basis) has the same disadvantages as the incurred loss approach. It does not view credit losses as an integral part of the lending decisions and is inconsistent with the initial measurement of a financial asset. Setting a threshold ignores the expected loss until the threshold is met and would lead to the same application problems that the incurred loss approach causes in practice.
13. Respondents who support the current incurred loss impairment approach also commented that moving to an expected loss approach would increase significant, subjective management estimates. However, estimating credit losses inevitably involves judgement irrespective of the impairment approach. The incurred loss approach (and the threshold approach mentioned in paragraph 14) leaves room for considerable judgement in determining *when* a loss event has occurred. Moving from an incurred loss to an expected loss approach *shifts* the judgement from identifying the loss event to measurement of the impairment loss. The expected loss approach reflects lending decisions more faithfully than the incurred loss approach and provides more relevant and useful information for the users.

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14. The Board also considered (but rejected) fair value based and through-the-cycle impairment approaches in its deliberation. Respondents to the ED overwhelmingly rejected these approaches mainly for the reasons set out in the ED's Basis for Conclusions³.

Lifetime expected loss versus short-term expected loss

15. Feedback from outreach activities and some respondents suggest that the impairment approach be based on short-term expected losses. Some argue that short-term expected losses can be measured more reliably and the approach would be operationally easier to implement. They argue that estimating lifetime expected loss increases management judgement and the uncertainty of the estimate.
16. In the staff's view limiting the impairment model to short-term expected losses does not reflect the underlying profitability of the financial asset. The profitability would exclude some credit losses on the basis of a cut-off for the outlook period and hence convey an incomplete picture. The short-term expected loss approach takes the view that only defaults in the short term are inherent in the portfolio. A short-term expected loss approach does not provide an appropriate link between the future profitability of the portfolio and expected credit losses. The pricing of the financial asset is set for the lifetime at origination and therefore the appropriate link to profitability can only be consistently established by taking lifetime expected losses. Taking short-term expected losses is also inconsistent with the initial measurement of a financial asset (implicit in the initial measurement of a financial asset is a deduction for the lifetime expected losses). This also means that any short-term expected loss approach does not provide a sound basis for adjusting the effective interest rate.

³ Paragraphs BC 15 to BC 24 of Basis for Conclusions on Exposure Draft *Financial Instruments: Amortised Cost and Impairment*

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17. The staff notes that finding a definitive cut-off definition for ‘short term’ is not possible. Any guidance we add on what is considered short term would only be an arbitrary cut-off rather than a principle-based approach. Furthermore, entities with sophisticated systems that can look beyond the arbitrary cut-off will be precluded from reporting based on better information. Like to today’s troublesome and divergent practice of determining what losses are incurred and what are future credit losses, finding a threshold for what losses are ‘short-term’ and what are ‘long-term’ losses will no doubt be elusive. In other words, such an approach would create a similar problem as the IAS 39 approach with the ‘incurred’ cut-off.
18. Some constituents suggest a short-term expected loss can be based on the Basel II 1-year expected loss under the Basel II internal ratings based approach. However, many agreed that the Basel II 1-year expected loss is an arbitrary cut-off. In its comment letter [CL 148], the Basel Committee have also proposed like the IASB’s ED to use lifetime expected loss⁴.
19. The EAP discussed how best to estimate lifetime expected losses. The EAP advised that in determining lifetime expected losses management should be able to use all available information, which may result in a combination of forecasts for shorter term estimates and long run averages for estimates relating to periods in the more distant future. We learnt that many entities can reasonably estimate expected loss in the short term. For financial products with longer maturities entities may revert to a long-term average loss rate as representing their best estimate of lifetime expected loss.

Implications of the types of expected loss estimate

20. In the staff’s view any expected loss approach other than lifetime expected loss has the following implications:

⁴ CL 148; Appendix A

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- (a) it would be inconsistent with an objective of amortised cost to portray the economic phenomenon of lending based on pricing of the financial asset and the overall profitability (ie including credit losses) of the financial asset; and
- (b) it would not be compatible with an effective interest rate adjustment approach and hence a present value based measurement (as there would not be a uniform discount rate).