
Project	Financial Instruments: Replacement of IAS 39 Amortised Cost and Impairment
Topic	'Good' book / 'bad' book distinction

Introduction

Background

1. In response to the feedback from comment letters on the exposure draft *Financial Instruments: Amortised cost and Impairment* (ED), the Expert Advisory Panel (EAP) and other outreach activities, the Board in its redeliberation has been developing an impairment model that is operational for open portfolios.
2. At previous meetings, the Board discussed a time-proportionate approach in combination with a 'good' book / 'bad' book distinction¹ as a possible impairment model for open portfolios. Consequently, the Board requested the staff to perform further analysis on an impairment model for which the balance in the allowance account for credit losses would be:
 - (a) determined using the time-proportionate approach to recognising expected loss (EL) for financial assets (for the remainder this paper refers to 'loans' but the analysis applies to all items that would be subject to the impairment model) in the 'good' book; and
 - (b) the full amount of total EL for the loans in the 'bad' book.

¹ See 3 August 2010 meeting (agenda paper 4B), 5 October 2010 meeting (agenda paper 3) and 18 October 2010 meeting (agenda paper 9B).

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 IFRIC or the IASB can make such a determination.

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Purpose

3. The purpose of this paper is to ask for direction from the Board, to be confirmed formally at a later stage, how the ‘good’ book and the ‘bad’ book be distinguished.

How financial institutions manage and assess credit risk and the notion of ‘good’ book / ‘bad’ book

4. The staff learnt from comment letters, outreach activities and the Expert Advisory Panel (EAP) that most financial institutions manage their lending business on a ‘good’ book / ‘bad’ book basis.
5. For most financial institutions, the loans in their ‘good’ book are usually those that management expects to be still collectible. For this reason, many respondents (as well as the EAP) who suggested (or support) the time-proportionate approach argue that the recognition of EL (both initial EL and subsequent changes) should follow the recognition of interest revenue and hence be allocated over the lifetime of the loan.² Allocation is directionally consistent with the objective of the ED given that credit losses need to be allocated because the compensation for credit losses that is implicit in the interest is also allocated over the life of the loan (as part of interest revenue in a decoupled approach). However, under the ED only the initial EL is allocated whereas subsequent changes are recognised immediately. As for loans in an entity’s ‘bad’ book, these are usually considered by management to be ‘non-performing’ because they do not expect it to be collectible. Hence, for these loans respondents suggested to recognise all EL immediately.
6. The rest of this section describes how the notion of a ‘good’ book / ‘bad’ book is embedded in the structure of most financial institutions’ credit risk management framework and their process for monitoring, assessing, measuring and managing

² Allocation is directionally consistent with the objective of the ED given that credit losses need to be allocated because the compensation for credit losses that is implicit in the interest is also allocated over the life of the loan (as part of interest revenue in a decoupled approach). However, under the ED only the initial EL is allocated whereas subsequent changes are recognised immediately.

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credit risk. (Note: most financial institutions also use the terms ‘good’/’bad’ and ‘performing’/’non-performing’ interchangeably.)

7. As described in paragraph 4 above, the loans in the management’s ‘good’ book are usually those that management expects to be collectible. EL on an entity’s ‘good’ book is typically assessed collectively on a portfolio-by-portfolio basis (especially for high volume low value loans). In many financial institutions, loss rates based on past experience adjusted for changes in circumstances (ie the qualitative adjustment to a historical loss rate) are applied to loan portfolios on the portfolio level.³
8. Within their ‘good’ book, most financial institutions would assess differently the loans or the groups of loans where closer assessment or monitoring is required (‘watch list’ loans). These loans usually have a higher degree of risk of non-payment. However, many financial institutions still consider these loans to be ‘performing’ because they still expect the loans to be collectible (albeit with increased uncertainty). Hence, most financial institutions would not typically *manage* them differently from other loans in the entity’s ‘good’ book.
9. As described in paragraph 4 above, loans that fall within the entity’s ‘bad’ book are those loans that management expects to be uncollectible. The loans in the ‘bad’ book are typically managed on an individual basis and separately from the entity’s ‘good’ book in specialised recovery units within the financial institution. In these specialised recovery units, loans are typically subject to intensified collection and recovery processes and credit risk exposure reduction.
10. For the loans in the entity’s ‘bad’ book, credit risk is typically assessed on an individual basis or using limited aggregation. In most international financial institutions (eg financial institutions under the Basel II Advanced Internal Ratings Based (AIRB) approach), the amount of impairment on these loans can be quantified on a reasonably accurate basis due to the intensified level of detailed credit assessment and management.

³ The staff has learnt from outreach activities that internationally only a very few financial institutions apply the loss rates at the individual loan level (ie on a loan-by-loan basis).

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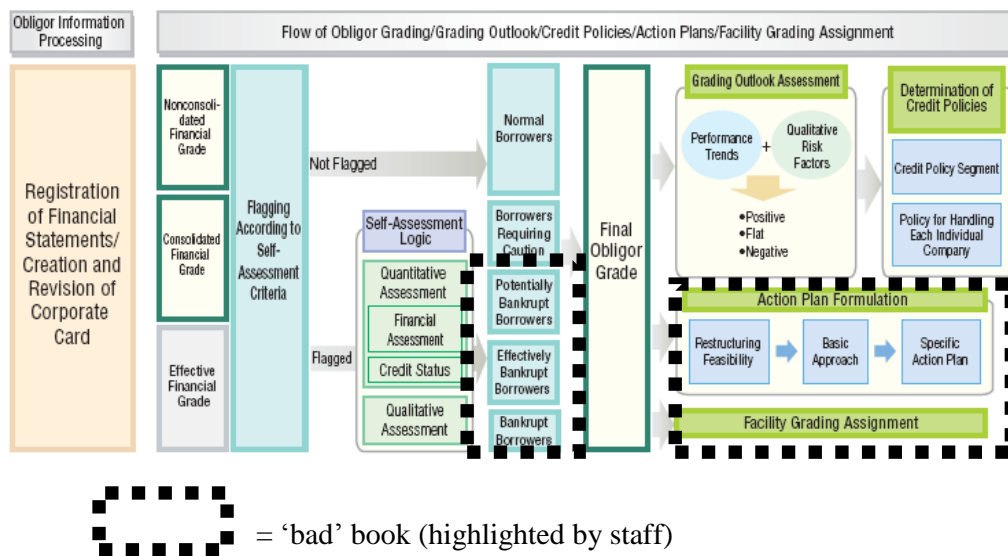
11. We learnt from our outreach and the EAP that the criteria for determining when a loan is moved from the entity's 'good' book to the 'bad' book (and hence is managed differently), differ across financial institutions and are dependent on the specific credit risk management practices/framework of each financial institution. For example, the credit risk management criteria for moving a loan to the 'bad' book can be 1 day overdue for one financial institution and 120 days overdue for another financial institution. The credit risk management criteria can also differ for different products within a financial institution (eg one missed payment for credit card products, but three missed payments for mortgages).
12. Furthermore, we learnt from the EAP and outreach activities that the credit risk management criteria for moving loans from the 'good' book to the 'bad' book are typically more objective and involve less judgement for large volume low value products that are typical of consumer lending (eg number of days overdue). For large wholesale products (eg high value corporate loans), there is usually more management judgement and subjectivity involved in assessing whether the loan should be transferred to the 'bad' book. The facts and circumstances are often assessed on a case-by-case basis (eg cash flows analysis, industry trends etc).
13. We also learnt from outreach activities and the EAP that there is a spectrum of different ratings within an entity's 'good' book. Within an entity's 'bad' book there are also different grades of 'bad' before the borrower is declared legally bankrupt. The grades used for assessing and quantifying credit risk form grade rating scales ranging from 3 to 14 internationally⁴. These grade ratings are also not standardised across different financial institutions or jurisdictions. However, the staff note that these grades would typically be grouped into two main distinct groups (ie 'good'/'bad' book) for credit risk management purposes.
14. We also learnt from outreach activities and the EAP that in most financial institutions, to ensure integrity of the credit risk management framework and policies, the grade ratings and the criteria and processes for defining when loans are moved into the entity's 'bad' book are subject to stringent and rigorous

⁴ Some financial institutions further sub-classify some grades into sub-grades.

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oversight by risk committees. These processes are also subject to internal and external audits.

- In our outreach, the staff and Board members spoke with many financial institutions. Following is a diagram of how loans are monitored, assessed and managed in one of the large international financial institutions that we reached out to⁵.



- For this particular financial institution ‘potentially bankrupt borrowers’, ‘effectively bankrupt borrowers’ and ‘bankrupt borrowers’ are more actively managed in its ‘bad’ book. For this particular financial institution, specific/individual provisions for EL are created for borrowers in the ‘bad’ book. For ‘normal borrowers’ and ‘borrowers requiring caution’, EL are provided for on a collective basis (ie at the portfolio level). Further details on the borrower categories and the write-off and provision policy for each borrower category are set out in Appendix A.

Alternatives and staff analysis

- The staff think the Board could at least consider pursuing the following alternatives in determining the ‘bad’ book:

⁵ Extract from annual report of a large international financial institution.

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- (a) Alternative 1: loans that are 90 days past due or unlikely to be paid; or
- (b) Alternative 2: based on internal credit risk management classification.

Staff analysis*Alternative 1*

18. A major criticism of today's incurred loss model in IAS 39 is that it has been interpreted and applied differently across different financial institutions and different jurisdictions. IAS 39 requires objective evidence of impairment as the result of a loss event. IAS 39 also sets out a list of loss events that, if observed, provide objective evidence of impairment. However, the staff have learnt from outreach and the EAP that in many cases significant management judgment and subjectivity are involved in the application of IAS 39 regarding when a loss is incurred, resulting in inconsistency and incomparability. Alternative 1 ensures that any loans that are at least 90 days past due would be in the 'bad' book. However, the staff note that management judgement would still be required to determine whether a loan is uncollectible if it is less than 90 days overdue, and hence incomparability could still exist across entities. .
19. The staff note that the 'bad' book definition in alternative 1 is consistent with the current default definition as set by the Basel Committee on Banking Supervision (Basel Committee). The Basel Committee sets 'best practice' standards and recommendations for prudential regulation in the expectation that each national prudential regulator will take steps to implement them.⁶ However, these standards and recommendations do not have the force of law. Hence, a jurisdiction could adopt a different definition of default. Furthermore, under the Basel definition of default a country supervisor may substitute a figure of up to 180 days for different banking products, as it considers appropriate to local conditions. Hence, it is not always the case that the accounting definition will align with the current regulatory definition in every jurisdiction that adopts or is

⁶ History of the Basel Committee and its Membership <http://www.bis.org/bcbs/history.htm>

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soon to adopt IFRS. Furthermore, the regulatory definition could change in the future.

20. Alternative 1 determines the ‘bad’ book for accounting purposes in a way that might not necessarily align with an entity’s determination of its ‘bad’ book. The staff note that 90 days overdue might not be in line with credit risk management practices in financial institutions and hence would add additional operational costs in ‘regrouping’ an entity’s loan book into the accounting definition of ‘good’ and ‘bad’ book (for example if an entity’s credit risk management policy is to move any credit card loans into its ‘bad’ book when the borrower is one day late in payment). Under alternative 1, an entity would be required to identify and ‘extract’ from the ‘bad’ book the loans that are still considered to be ‘good’ for accounting purposes. Hence, alternative 1 could result in entities keeping two sets of ‘good’ book and ‘bad’ book, one for management purposes and one for accounting purposes.
21. The staff also note that alternative 1 may not entirely reflect how loans are managed by the entity. However, the staff note that the Board could consider requiring disclosures about how an entity determines the ‘good’ book / ‘bad’ book as set out in paragraph **Error! Reference source not found.** as additional supplement information for users if the entity manage loans on a ‘good’ book / ‘bad’ book basis. (The staff plan to discuss the potential direction on disclosures for open portfolios in more detail at a later meeting.)

Alternative 2

22. Alternative 2 allows the ‘bad’ book to be determined for accounting purposes in a way that is aligned with an entity’s ‘bad’ book determination for its credit risk management purposes. Hence, alternative 2 conveys information about the loans for which management regard as still collectible and the loans that are no longer collectible for which losses should be recognised immediately.
23. Under alternative 2, the timing for when loans are moved to the ‘bad’ book could differ across products, entities, and jurisdictions. However, the staff believe this reflects the difference in risk and economic characteristics of the different financial products and the management strategy in managing these

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different products (see paragraphs 11 and 12). The staff further note that the ED has already proposed that entities disclose a reconciliation of changes in non-performing financial assets (defined as more than 90 days past due or considered uncollectible) as a platform for users to compare information across entities and jurisdictions.

24. The staff acknowledge that there could be instances where an entity does not manage its loans based on a ‘good’ book / ‘bad’ book approach. (However the staff note that the staff suggest in agenda paper 1A of this meeting that short-term-trade receivables be excluded from the upcoming ED for open portfolios. A similar suggestion is in agenda paper 1D for items other than those in open portfolios. Hence this could be in very limited instances.) In those cases, the staff think that the Board could consider:
- (a) alternative 1 as set out in paragraph 17(a); or
 - (b) setting criteria for the ‘bad’ book. The Board could consider for example to the following criteria:
 - (i) when management considers that the entire EL of the loan should be recognised immediately rather than allocating the EL because the uncertainty about its collectibility has taken precedence over the profitability from the interest margin; and/or
 - (ii) allocation of EL would no longer be appropriate because it results in a return that is below the risk free rate.
25. The staff consider that disclosures are essential. Under alternative 2, an entity could be required to disclose:
- (a) how the loans are managed in the ‘good’ book and in the ‘bad’ book (including the criteria set for moving loans from the ‘good’ book to the ‘bad’ book);⁷ and
 - (b) how credit risk and EL are assessed and estimated for the entity’s ‘good’ book and for its ‘bad’ book.⁸

⁷ The staff note that how loans are managed in the ‘good’ book / ‘bad’ book could differ for different products.

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26. The staff believe that the above disclosures could provide useful information to users in the context of this particular impairment model (ie the time proportionate approach in combination with a ‘good’ book / ‘bad’ book distinction).
27. Appendix B provides an excerpt with information about the credit risk management policies of an international financial institution as part of its risk review in its annual report. The staff found such information provides relevant, transparent and insightful information on the entity’s credit management processes, including how the entity assesses, measures and provides for credit losses. (The staff plan to discuss in more detail at the a later meeting the potential direction on disclosures for the forthcoming impairment ED for open portfolios.)
28. The staff note that alternative 2 could give rise to concern over potential earnings management because of the effect of movements between the ‘good’ and the ‘bad’ book on the timing of the recognition of EL. The staff note that determining the timing of losses nevertheless involves significant management judgement, even if a specific bright line is set for eg 90 days as under alternative 1. This is because that specified number of days is only the last point in time when a loan would have to be considered impaired but the assessment would still involve the evaluation of whether there are other circumstances that result in an earlier determination of the loan as impaired. The staff also note the feedback received from auditors that financial reporting information that is linked to internal management policies/processes and reporting is more robust and facilitates better audits.
29. The staff also note that alternative 2 is directionally consistent with phases I and III of the project to replace IAS 39. One of the classification criteria for financial assets in IFRS 9 is based on the entity’s business model for managing the financial asset. The accounting under alternative 2 reflects the way in which these financial assets are managed. Phase III, the soon to be published exposure draft on hedge accounting also aims to improve financial reporting by enabling

⁸ The staff note credit risk and EL are assessed and estimated could differ for different products.

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entities to better reflect their risk management. Alternative 2 also provides transparency to users on the credit risk management by entities.

Closing and direction

30. The staff consider that while alternative 1 would likely result in a higher degree of consistency across entities (any loans that are more than 90 days over due will be in the ‘bad’ book), it would not always reflect how loans are managed. The staff note that although alternative 1 is to a large extent aligned with the regulatory definition (of non-performing), it is not always the case for all jurisdictions and the regulatory definition might change in the future. Alternative 1 could also give rise to additional costs for entities in setting up a separate ‘good’ book / ‘bad’ book solely for accounting purposes.
31. Alternative 2 allows entities to convey information on those loans that management considers to be collectible and those that management considers as no longer collectible. Entities may rely on their credit risk management policy of ‘good’ book / ‘bad’ book and hence would not impose additional costs to entities in setting up a new ‘good’ book / ‘bad’ book solely for accounting purposes.
32. Given the variety of different financial products and the innovation of yet more new lending products in the future, alternative 2 allows the accounting to reflect products that in the management’s view are collectible. Disclosures of what the entity consider as ‘bad’ or ‘non-performing’ could be required to provide transparent and useful information to users on how loan portfolios are assessed and provided for by entities.
33. The staff further note that the role that the corporate governance structure (ie risk committees, external and internal audits) plays should also be considered when evaluating the alternatives.

Question

Which alternative does the Board think is the appropriate direction to pursue?

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If the Board does not think either of the alternatives should be pursued, what other alternative should be pursued and why??

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Appendix A

- A1. Appendix A sets out extracts from an annual report of a large international financial institution.
- A2. The following table sets out the obligor grading system for each loan.

Obligor Grade		Definition	Borrower Category	Financial Reconstruction Law-Based Disclosure Category (Domestic)
Domestic (C&I), etc.	Overseas (C&I), etc.			
J1	G1	Very high certainty of debt repayment	Normal Borrowers	Normal Assets
J2	G2	High certainty of debt repayment		
J3	G3	Satisfactory certainty of debt repayment		
J4	G4	Debt repayment is likely but this could change in cases of significant changes in economic trends or business environment		
J5	G5	No problem with debt repayment over the short term, but not satisfactory over the mid to long term and the situation could change in cases of significant changes in economic trends or business environment		
J6	G6	Currently no problem with debt repayment, but there are unstable business and financial factors that could lead to debt repayment problems		
J7	G7	Close monitoring is required due to problems in meeting loan terms and conditions, sluggish/unstable business, or financial problems	Borrowers Requiring Caution	Substandard Loans
J7R	G7R	(Of which Substandard Borrowers)	Substandard Borrowers	
J8	G8	Currently not bankrupt, but experiencing business difficulties, making insufficient progress in restructuring, and highly likely to go bankrupt	Potentially Bankrupt Borrowers	Doubtful Assets
J9	G9	Though not yet legally or formally bankrupt, has serious business difficulties and rehabilitation is unlikely; thus, effectively bankrupt	Effectively Bankrupt Borrowers	Bankrupt and Quasi-Bankrupt Assets
J10	G10	Legally or formally bankrupt	Bankrupt Borrowers	

- A3. The following tables sets out the definitions of each borrower category and asset classifications.

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Borrower Categories, Defined	
Normal Borrowers	Borrowers with good earnings performances and no significant financial problems
Borrowers Requiring Caution	Borrowers identified for close monitoring
Potentially Bankrupt Borrowers	Borrowers perceived to have a high risk of falling into bankruptcy
Effectively Bankrupt Borrowers	Borrowers that may not have legally or formally declared bankruptcy but are essentially bankrupt
Bankrupt Borrowers	Borrowers that have been legally or formally declared bankrupt

Asset Classifications, Defined	
Classification I	Assets not classified under Classifications II, III, or IV
Classification II	Assets perceived to have an above-average risk of uncollectibility
Classification III	Assets for which final collection or asset value is very doubtful and which pose a high risk of incurring a loss
Classification IV	Assets assessed as uncollectible or worthless

A4. The following table sets out the write-off and provision criteria for each borrower category.

Self-Assessment Borrower Categories		Standards for Write-Offs and Provisions
Normal Borrowers		The expected loss amount for the next 12 months is calculated for each grade based on the grade's historical bankruptcy rate, and the total amount is recorded as "provision for the general reserve for possible loan losses."
Borrowers Requiring Caution		These assets are divided into groups according to the level of default risk. Amounts are recorded as provisions for the general reserve in proportion to the expected losses based on the historical bankruptcy rate of each group. The groups are "claims on Substandard Borrowers" and "claims on other Borrowers Requiring Caution." The latter group is further subdivided according to the borrower's financial position, credit situation, and other factors. Further, when cash flows can be estimated reasonably accurately, the discounted cash flow (DCF) method is applied mainly to large claims for calculating the provision amount.
Potentially Bankrupt Borrowers		A provision for the specific reserve for possible loan losses is made for the portion of Classification III assets (calculated for each borrower) not secured by collateral, guarantee, or other means. Further, when cash flows can be estimated reasonably accurately, the DCF method is applied mainly to large claims for calculating the provision amount.
Effectively Bankrupt/ Bankrupt Borrowers		Classification III asset and Classification IV asset amounts for each borrower are calculated, and the full amount of Classification IV assets (deemed to be uncollectible or of no value) is written off in principle and provision for the specific reserve is made for the full amount of Classification III assets.
Notes	General reserve	Provisions made in accordance with general inherent default risk of loans, unrelated to specific individual loans or other claims
	Specific reserve	Provisions made for claims that have been found uncollectible in part or in total (individually evaluated claims)

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Appendix B

- B1. Appendix B sets out extracts from the risk review section of annual report of a large international financial institution. The staff thinks that the following information could be useful for users, in providing transparent and relevant information on how an entity measures, monitor, assess and provides for credit losses.

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Credit monitoring

We regularly monitor credit exposures, portfolio performance, and external trends which may impact risk management outcomes.

Internal risk management reports are presented to risk committees, containing information on key environmental, political and economic trends across major portfolios and countries; portfolio delinquency and loan impairment performance; as well as IRB portfolio metrics including credit grade migration.

The Wholesale Banking Credit Issues Forum, which is a sub-committee of the Wholesale Banking Risk Committee, meets regularly to assess the impact of external events and trends on the Wholesale Banking credit risk portfolio and to define and implement our response in terms of appropriate changes to portfolio shape, underwriting standards, risk policy and procedures.

Corporate accounts or portfolios are placed on Early Alert (EA) when they display signs of weakness or financial deterioration, for example, where there is a decline in the customer's position within the industry, a breach of covenants, non-performance of an obligation, or there are issues relating to ownership or management.

Such accounts and portfolios are subjected to a dedicated process overseen by Group Special Assets Management (GSAM), our specialist recovery unit. Account plans are re-evaluated and remedial actions are agreed and monitored. Remedial actions include, but are not limited to, exposure reduction, security enhancement, exiting the account or immediate movement of the account into the control of GSAM.

In Consumer Banking, portfolio delinquency trends are monitored continuously at a detailed level. Individual customer behaviour is also tracked and informs lending decisions. Accounts which are past due are subject to a collections process, managed independently by the Risk function. Charged-off accounts are managed by specialist recovery teams. In some countries, aspects of collections and recovery functions are outsourced.

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Problem credit management and provisioning

Consumer Banking

In Consumer Banking, where there are large numbers of small value loans, a primary indicator of potential impairment is delinquency. However, not all delinquent loans (particularly those in the early stage of delinquency) will be impaired. Within Consumer Banking an account is considered to be delinquent when payment is not received on the due date. For delinquency reporting purposes we follow industry standards, measuring delinquency as of 1, 30, 60, 90, 120 and 150 days past due. Accounts that are overdue by more than 30 days are more closely monitored and subject to specific collections processes.

Provisioning within Consumer Banking reflects the fact that the product portfolios (excluding medium enterprises among SME customers and private banking customers) consist of a large number of comparatively small exposures. As a result, much of the provisioning is initially done at an account level for each product and a portfolio impairment provision (PIP) is raised on a portfolio basis. PIP is set using expected loss rates, based on past experience supplemented by an assessment of specific factors affecting the relevant portfolio. These include an assessment of the impact of economic conditions, regulatory changes and portfolio characteristics such as delinquency trends and early alert trends. The PIP methodology provides for accounts for which an individual impairment provision has not been raised.

For the main unsecured products and loans secured by automobiles, the entire outstanding amount is generally written off at 150 days past due. Unsecured consumer finance loans are similarly written off at 90 days past due. For secured loans (other than those secured by automobiles) individual impairment provisions (IIP) are generally raised at either 150 days (mortgages) or 90 days (other) past due.

The provisions are based on the estimated present values of future cashflows, in particular those resulting from the realisation of security. Following such realisation any remaining loan will be written off. The days past due used to trigger write offs and IIP are broadly driven by past experience, which shows that once an account reaches the relevant number of days past due, the probability of recovery (other than by realising security where appropriate) is low. For all products there are certain situations where the individual impairment provisioning or write off process is accelerated, such as in cases involving bankruptcy, fraud and death. Write off and IIP is accelerated for all restructured accounts to 90 days past due (unsecured and automobile finance) and 120 days past due (secured) respectively.

The procedures for managing problem credits for the Private Bank and the medium enterprises in the SME segment of Consumer

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Banking are similar to those adopted in Wholesale Banking (described on page 58).

Wholesale Banking

Loans are classified as impaired and considered non-performing where analysis and review indicates that full payment of either interest or principal is questionable, or as soon as payment of interest or principal is 90 days overdue. Impaired accounts are managed by our specialist recovery unit, GSAM, which is separate from our main businesses. Where any amount is considered irrecoverable, an individual impairment provision is raised. This provision is the difference between the loan carrying amount and the present value of estimated future cash flows.

The individual circumstances of each customer are taken into account when GSAM estimates future cash flow. All available sources, such as cash flow arising from operations, selling assets or subsidiaries, realising collateral or payments under guarantees, are considered. In any decision relating to the raising of provisions, we attempt to balance economic conditions, local knowledge and experience, and the results of independent asset reviews.

Where it is considered that there is no realistic prospect of recovering a portion of an exposure against which an impairment provision has been raised, that amount will be written off.

As with Consumer Banking, a PIP is held to cover the inherent risk of losses which, although not identified, are known through experience to be present in any loan portfolio. In Wholesale Banking, this is set with reference to historic loss rates and subjective factors such as the economic environment and the trends in key portfolio indicators. The PIP methodology provides for accounts for which an individual impairment provision has not been raised.