IFRS

Staff
Paper

**IASB/FASB Joint meeting
Week of 13-17 December, 2010**

IASB
Agenda
reference   **5**

Project	**Accounting for Financial Instruments: Impairment**
Topic	**Feedback on Alternative 4A**

Introduction

1.   At the 17 November 2010 meeting, the boards discussed a variety of alternative models for recognition of credit impairment with the objective of identifying those alternatives that would satisfy the individual objectives of each board. That discussion resulted in narrowing down the models under consideration from seven alternatives to three alternatives (labelled Alternatives 2, 4 and 5) which were discussed at the 8 December 2010 meeting.

2.   At that meeting, the boards discussed AP1/Memo 75, which provided discussion around each of the models (including two variations for Model 5). It described each model for the recognition of credit losses, its principle, the resulting presentation of amounts in the financial statements and pros and cons of each model. The paper also compared and contrasted the models using illustrations. The boards also discussed AP1A/Memo 75A, which presented a variation on Alternative 4.

3.   During that discussion the boards tentatively decided to pursue Alternative 4A (also referred to as 4 prime during the discussions) which involves the recognition of lifetime expected credit losses using a time-proportionate approach for a good book and full recognition of lifetime expected losses for a bad book with a floor for the good book to ensure that the allowance balance in the good book was always sufficient to cover expected losses (EL) in the upcoming year.

4.   The boards agreed on the principle of the model, but wanted to explore different options for the timing of the floor, including:

    (a)   a 12-month EL estimate being the losses expected on the assets/portfolio over the next 12 months; or

    (b)   a loss estimate based on the amount of credit losses expected to occur within a period that can be reliably estimated being no less than 12 months.

5.   The boards asked staff from both organisations to obtain feedback on the operational feasibility of the model and of the proposed criteria to determine the division between the good book and bad book. The purpose of this paper is to share the results of the feedback conducted by the IASB staff.

Outreach efforts

6.   The IASB staff prepared a brief summary of the proposed model to distribute to the Basel committee and a number of international banks. The summary is included as Appendix A to this paper and asked the following questions:

    (a)   Would imposing a 'higher of' test for a floor amount be operational? Why or why not?

    (b)   Would it be operational to establish the floor for a specific time period (eg a 12-month expected loss estimate)? Alternatively, would a period described as in paragraph 4(b) above be operational (eg a reliably estimated amount, but no less than 12 months)? Why or why not? Other than operational issues do you have any other reasons for preferring a specific period to the approach set out in paragraph 4 above – please explain why.

    (c)   Is the proposed good book / bad book split operational? Why or why not?

    (d)   Do you have any suggestions to make the split more operational?

Results of outreach – Basel

7. The Basel Committee on Banking Supervision (BCBS) provided informal feedback which indicated support for Alternative 4A. The BCBS indicated that the approach would be operational using either of the proposed criteria for determining the floor. However, the BCBS would prefer use of the 'reasonably foreseeable future' criteria, linked to the reliability of the estimate, to the 12-month EL estimate because it would provide a more adequate allowance.

8. Regarding the good book/bad book split, the BCBS would prefer that the bad book is not limited just to past-due and non-performing loan. They also suggested we use the term 'problem' loans so that banks with less sophisticated systems (ie no good book/bad book split) will still be able to apply the guidance.

9. The BCBS provided several suggestions to make the proposal more operational and acknowledges it will need to develop supervisory guidance to discuss supervisory considerations once the EL impairment model is finalised.

Results of outreach – International banks

10. Staff held a conference call with several banks that operate in various countries. The banks emphasised that when an entity has information that allows identifying a specific (eg non-linear) loss pattern, the entity should be able to use that data to allocate EL. For less sophisticated institutions a standardised loss curve might be used as a practical expedient. The use of a specific loss pattern or standardised loss curves, if available, would meet the objective of the floor without the additional complexity. If no specific loss curves are available (including financial assets for which no specific loss curves can be identified), using the proportional approach in conjunction with a floor might be a fallback solution. The banks provided the following additional feedback on the model's operationality:

11. General comments about establishing a floor:

   (a) Introducing a floor compromises the time-proportional approach and adds operational complexity, calculating two sets of EL and comparing them each term to determine the required reserve amount.

   (b) The EAP proposal (which is consistent with the ED) seeks to ensure that Interest Revenue and Cost Matching is maintained in the same accounting period, with recognition of EL adjusted income earned against the asset carrying value.

   (c) Statistically based loss curve patterns should be used where these can be developed, including any adjustment necessary for non-linear loss patterns (eg where loss patterns are front loaded). If necessary, standardised loss curves could be used as a practical expedient. The expectation is that the straight-line approach will be appropriate for most cases. At a minimum the straight-line approach should be used to allocate expected lifetime EL (ie the loss expectation should not be back loaded).

   (d) Where preparers cannot create statistically robust loss curve patterns, then, as a practical expedient, a floor should be used to guard against any under provisioning in early period loss patterns before earnings have materialised. Typically this will apply to smaller firms or large firm portfolios where robust statistical approaches do not exist.

12. 12 months vs. reliably estimated period:

   (a) If 'setting a floor' is a given condition, there is a strong preference to use 1 year (12 months) EL (because of alignment with Basel requirements, parameters, annual accounting term) as opposed to a 'reliably estimated' period.

   (b) Regulatory measures should be allowed to be used where these exist, with disclosure to explain the approach followed. Otherwise a level of operational complexity is introduced for minimal obvious benefit.

   (c) A 12-month EL estimate should be 'forward looking' assuming open portfolio conditions (ie allowing for replacement assets). Otherwise

additional operational complexity is created as the amount is no longer meaningful in an open portfolio context.

(d) How would preparers draw a line between a 'reliable estimate' and a 'non-reliable estimate'? This, in itself, could create significant operational complexity.

(e) Defining 'foreseeable future' introduces comparability issues which would lead to operational challenges in terms of disclosure.

13. Good book/bad book split

(a) The line between the good book and bad book should be based on the quality of the asset, not the method of calculation (ie portfolio vs. individual).

(b) The good/bad book split should be grounded in the preparer's risk management practices, and in order to avoid potential unintended consequences, consideration given to introducing a backstop measure - possibly based upon Basel or regulatory definitions. As all preparers are not subject to the same regulations, a simple backstop measure based on days past due may be required.

(c) Flexibility should be maintained in terms of 'collectable/uncollectable' definitions. As these are terms which are open to interpretation, disclosure should be used to develop market convergence.

14. Further simple worked examples are required to ensure that the outcome is in line with the boards' expectations. These should differentiate between homogenous pools of assets, show where loss patterns are non linear, and how smaller 'big ticket' items would perform as seen in heterogeneous portfolios.

Appendix A: Alternative 4A - Recognition of lifetime expected credit losses using a time-proportionate approach and a possible 'floor'

Description

1. This model is based on one of the approaches that the Expert Advisory Panel (EAP) put forward as addressing the operational difficulties of the IASB exposure draft *Amortised Cost and Impairment* (IASB ED) for open portfolios. It maintains the relationship between interest and loss expectations that was a fundamental aspect of the IASB ED. With an add-on feature of a good book 'floor', it addresses the concerns raised by some of potentially not having a high enough balance in the allowance account to cover losses expected in the near term.

2. The time-proportionate approach we would like your thoughts on would have the following main features:

    (a) *Amount of credit loss estimate*: The credit loss estimate would be the full amount of the credit losses expected over the life of the portfolio of assets. Unless otherwise specified, the expected loss (EL) amounts referred to in this paper therefore refer to lifetime ELs. However, the timing of recognition of such losses would depend on whether an asset is in a good book or in a bad book (see discussion below related to good book / bad book approach). The allowance account would represent the sum of the amounts for the bad book and good book calculated as determined below.

    (b) *Timing of recognition of credit losses – bad book*: The EL estimate is always <u>fully provided for</u> (so when an asset, or group of assets, is moved to the bad book the lifetime ELs are recognised fully in the allowance account at that time, as are the effects of any subsequent changes in EL estimates on the bad book).

    (c) *Timing of recognition of credit losses – good book*: The EL provided for is determined each period as the 'higher of':

(i) *Time-proportionate EL:* The EL estimate at the reporting date for the assets in the portfolio at that date apportioned for age of the portfolio (ie lifetime EL X (weighted average age (WAA)/weighted average life (WAL))). At each reporting date the amount would be recalculated based on the EL, WAA and WAL at that time.; and

(ii) *Floor amount:* Two alternative floor amounts are being considered:

(1) A 12-month expected loss estimate being the losses expected on the assets/portfolio over the next 12 months.

(2) A loss estimate based on the amount of credit losses expected to occur within a period that can be reliably estimated being no less than 12-months.

Questions

Would imposing such a 'higher of' test for a floor amount be operational? Why or why not?

Would it be operational to establish the floor for a specific time period (eg a 12-month expected loss estimate)? Alternatively, would a period described as in 2(c)(ii)(2) above be operational (eg a reliably estimated amount, but no less than 12 months)? Why or why not? Other than operational issues do you have any other reasons for preferring a specific period to the approach set out in 2(c)(ii)(2) or vice versa – please explain why.

Good book / bad book

Background

3. As outlined above the model being investigated would determine the timing of loss recognition based on allocating loans between good and bad books. The staff learnt from comment letters, outreach activities and the EAP that most financial institutions manage their lending business on a 'good' book / 'bad' book basis.

4. The loans in 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.[1]

5. 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.

6. 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.

Good book / bad book split

7. We are investigating whether the 'bad' book could be determined for impairment accounting purposes in a way that is aligned with an entity's 'bad' book determination for its credit risk management purposes. This would convey information about the loans which management regards as still collectible and the loans that are no longer collectible for which losses should be recognised immediately. Guidance would be provided for determining the appropriate bad book criteria through an objective that the bad book encompass loans where the uncertainty about collectability has taken precedence over the profitability from the interest margin.

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[1] 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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Questions
Is the proposed good book / bad book split operational? Why or why not?
Do you have any suggestions to make the split more operational?