Project **Financial Instruments: Impairment**

Topic **Cover paper**

In the interests of time the series 8 papers have been posted for discussion on 17 December 2010. However, these papers are dependent on the outcome of the joint discussion of the Boards on 16 December 2010 and assume that the IASB is continuing to discuss either Alternative 4 or 4A following that meeting.

Background

1. Since July 2010, the Board has been considering how to address the feedback received on the exposure draft *Financial Instruments: Amortised Cost and Impairment* (the ED). In summary, the feedback received was that most respondents agreed with a more forward-looking impairment approach based on expected credit losses, but that the expected cash flow model proposed in the ED was operationally difficult.

2. As noted in previous papers, the staff (as well as many respondents) believe that the model proposed in the ED faithfully represents the underlying economics included in the pricing of financial instruments and is consistent with the amortised cost measurement in IFRSs. However, the staff believe the Board needs to consider how the proposed approach should be altered to address the significant operational challenges identified. Most notably, with open portfolios.

3. The Board has already discussed the general *mechanics* and particular unique implications of several decoupling methods for allocating expected loss (EL)

estimates[1]. The Board has also discussed several different general alternatives for credit impairment jointly with the Financial Accounting Standards Board (FASB)[2].

4. As a result of these discussions, the Boards agreed at the 8 December 2010 joint meeting to further develop and jointly discuss an approach which requires the recognition of lifetime expected credit losses using a time-proportionate approach with a 'good' / 'bad' book and a floor for the good book. The actual amount recorded for the 'good' book allowance would be the *higher of* the time-proportionate amount calculated for the allowance balance, or the floor amount. There are two possible floor amounts being considered:

   (a) a 12-month EL estimate for the assets in the portfolio; or

   (b) an EL 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 IASB aims to issue an exposure draft on the revised model in the near term. Through 30 November 2010 the Board has made tentative decisions and provided direction during redeliberations to proceed with developing an approach for open portfolios that:

   (a) is based on ***lifetime*** EL;

   (b) considers ***all*** reasonable and supportable information (including specific projections of future conditions) when calculating EL;

   (c) allocates the EL estimate over the lifetime for performing or 'good' loans using a ***time-proportionate approach***;

   (d) recognizes the full EL on the bad book; and

   (e) uses a non-integrated (ie ***'decoupled'***) approach when allocating the lifetime EL and recognising interest revenue.

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[1] See agenda paper 3 of the 5 October 2010 meeting and agenda papers 9, 9A, 9B of October 2010 meeting.

[2] See joint agenda papers 1, 1B and 1C from the 10-12 November 2010, joint agenda papers 13, 13A and 13B from the 17 November 2010 meeting and joint agenda papers 1 and 1A from the 8 December meeting.

6. At an IASB-only meeting on 1 December 2010, the Staff asked the Board for further direction on how to continue to develop the model[3]. The Board discussed the scope of the upcoming ED, allocation of lifetime expected losses under ‘decoupling’ and how the ‘good book’ and the ‘bad book’ could be defined or identified. At this meeting, the Board did not formally vote, but directed the staff as described in agenda paper 8A.

Topics for today’s meeting

7. There are three topics for discussion:

   (a) **Agenda paper 8A – Confirm direction from IASB-only meeting on 1 December** - As noted above, the Board discussed the scope of the upcoming ED, allocation of lifetime expected losses under a ‘decoupled’ approach and movement of loans from the ‘good’ book to the ‘bad’ book at the 1 December meeting. The Board did not officially vote on these issues, but did provide direction to the staff. Therefore, at this meeting we will ask the Board to confirm that - consistent with the directions previously given to the staff - for purposes of the upcoming ED:

      (i) short-term trade receivables should be excluded from the scope of the upcoming ED [agenda paper 1A from 1 December 2010 meeting];

      (ii) the scope of the upcoming ED will focus on financial assets included in an *open portfolio*, but a question will be posed to ask for specific feedback on the applicability of the model to other instruments (including closed portfolios and single instruments) [agenda paper 1D];

      (iii) for the ‘good’ book the time-proportionate amount of the revised lifetime EL estimate will be attributed to the relevant period using either a straight-line approach (discounted or undiscounted) or an annuity approach. Entities may use a discount rate that lies between the risk-

[3] See agenda papers 1, 1A, 1B, 1C and 1D from the 1 December meeting.

free rate and the IAS 39 effective interest rate (there will be a question asked in the revised ED as to whether a particular approach should be required) [agenda paper 1B]; and

(iv) loans would be transferred from the 'good' book to the 'bad' book according to the entity's internal credit risk management criteria or where the uncertainty about collectability has taken precedence over the profitability from the interest margin [agenda paper 1C].

In this paper we will also ask the Board for permission to draft the exposure draft and ask whether any Board members intend to dissent to the upcoming exposure draft.

(b) Agenda paper 8B – Presentation and disclosure

(c) Agenda paper 8C – Scope of upcoming ED: loan commitments and financial guarantee contracts