Project **Accounting for Financial Instruments**

Topic **Impairment—Timing of Credit Loss Recognition**

Introduction

1. The purpose of this staff paper is to discuss issues surrounding the timing of recognition of credit losses within a credit impairment model.

2. The decision on when an entity should recognize expected credit losses (both initial estimates and subsequent changes) on financial assets is one of the key decisions to be made with respect to the recognition of credit impairment losses. The timing of recognition is inherently linked to the other elements of the credit impairment model. Decisions on the amount and timing of credit loss recognition will form the basis for articulating the objective of the allowance for credit losses and the carrying value of the related financial assets.

3. In an open portfolio setting, it is not possible to distinguish between initial estimates and subsequent changes in those estimates. Therefore, this paper is written in the context that all expected credit losses (both initial estimates and subsequent changes in estimates) would receive the same accounting treatment. The paper does not address initial estimates and subsequent changes separately.

4. The remainder of this paper discusses alternatives, additional issues to consider, and financial statement presentation under the alternatives.

5. This paper uses the following terminology:

a) *Expected life* means how long the loans within the portfolio are expected to be outstanding (considering data on prepayments, loan renewals, and defaults); it is more precise to determine the *weighted average expected life* of the portfolio

b) *Weighted average age* means the point in the expected life of outstanding loans within a portfolio of loans determined based on the weighted average remaining lives of those loans.

Alternatives

6. The following are alternatives for the timing of recognition of impairment losses:

   (a) Alternative 1: Immediate recognition

   (b) Alternative 2: Recognition over time

7. Pros and cons, additional issues, and the financial statement presentation of credit losses under each alternative are discussed in the sections below.

Alternative 1: Immediate recognition

8. One alternative is for an entity to recognize all expected credit losses in the current period (immediate recognition). Under this alternative, the estimate of credit losses would be recognized in the period the estimate would be made. Mechanically, this would result in recognizing changes in expectations in the income statement and as an adjustment of the allowance for credit losses in the period of the change, thereby permitting recognition of both favorable and adverse changes in expected credit losses.

Pros

9. *Addresses fundamental problems with current impairment model* Many believe that the fundamental problem with the current impairment model under both U.S. GAAP and IFRS is that reserves for credit losses tend to be at their lowest level before an economic cycle trends downward and actual losses begin to emerge. Eliminating the incurred loss notion currently required under both U.S. GAAP and IFRS partially addresses this issue due to perceived accounting limitations to increasing reserves. However, some (including U.S. Banking Regulators) have expressed that to resolve this fundamental problem, the impairment model would need to (a) incorporate forecasts, (b) increase the coverage period (for example, consider losses that an entity expects to occur over the life of the loans) and (c)

set the allowance to the amount of credit losses that are expected by management at each reporting date. Items (a) and (b) in the preceding sentence are considered in developing the amount of the credit loss estimate (see Agenda Paper 1B / Memorandum 69), while the third relates to timing of recognition of those expected credit losses. The primary reason for supporting immediate recognition of expected credit losses is that the balance sheet would reflect a reserve that fully covers the amount of credit losses expected by management, given the information considered in making the estimate and the coverage period specified. This is more of a prudence argument than an economic argument.

10. *Accommodates open portfolios* As discussed in IASB Agenda Paper 3 (October 5, 2010), in an open portfolio setting, it is not possible to distinguish between expected loss estimates on new financial assets and the effects of changes in estimates for existing assets. Immediate recognition does not require that such a distinction be made because it considers the portfolio at a point in time based on the weighted average life of the loans, regardless of the age of the individual financial assets included in the portfolio.

11. *Reduced operational complexity* Recognizing both initial expected credit losses and subsequent changes in expectations immediately eliminates some of the complexity of a model that would require allocation.

12. *Conveys allowance balance information to users* The allowance balance and impact on current period earnings can be easily explained and understood by users of financial statements.

Cons

13. *Does not convey economic information to users* Because losses do not occur in a single period, immediate recognition may not be an accurate reflection of the economics of lending activity. Rather, a method that would recognize credit losses over time may achieve the proper matching of revenue associated with the loan and credit impairment expense if this matching is desired. In addition to not conveying the economics of the lending activity, this approach would not convey

useful information related to the emergence period for losses or interest income recognition. However, unless the timing of the loss is known, allocation approaches attempting to match impairment expense to interest revenue also may not provide an accurate reflection of the economics of lending activities.

14. *"Day 1" loss recognition* Some have expressed concern that an approach that requires immediate recognition of expected credit losses results in recognizing a Day 1 loss. This is a concern because this means that a loss could be recognized on a loan even if there was no faulty underwriting on the loan and even though the interest rate charged includes an expectation of credit losses by considering loss data for loans with similar risk characteristics and traits. In other words, a loss is recognized even when no economic event has happened. Others believe that this is not a compelling issue because, conceptually, in an open pool, there is no "day 1" (beginning date) or maturity date. Pools are fluid because loans are added and removed (via maturity) on an ongoing basis. Further, the allowance is not allocated to the loans within the pool, but rather held against the full pool at that point in time, so there is no loss upon origination or acquisition of any particular loan.

15. *Significant earnings and capital impact* Some are concerned about the need to recognize a charge for the total amount of expected losses immediately, which would significantly increase an entity's allowance for credit losses. The FASB staff believes there could be a significant increase in reserves for some financial institutions at transition and going forward for a certain time period. In other words, the staff believes that this significant impact would occur upon initial application of a final standard and would therefore likely be captured within the cumulative effect. Also, a model that requires immediate recognition of expected credit losses would result in a potentially significant charge for banks that initiate significant new loan underwriting programs (e.g., with new markets or new products). Some believe that an immediate recognition approach would distort the expectations of those new markets or products. At the beginning of a new product's life, it may appear to be unprofitable because of the immediate

recognition of all expected losses. Therefore, they feel that this approach would provide misleading information to users. Others may believe it is appropriate for the allowance to increase as a result of a significant increase in lending activity.

Alternative 2: Recognition over time

16. A second alternative is to recognize expected credit losses over time. For the purposes of this paper, we will assume that the timeframe for recognition is the expected life of the financial assets.

Pros

17. *Addresses fundamental problems with current impairment model* Similar to Alternative 1, eliminating the incurred loss notion currently required under both U.S. GAAP and IFRS partially addresses this issue due to perceived accounting limitations to increasing reserves. Further, this model would incorporate forecasts and consider lifetime expected losses.

18. *Conveys information about the economics of lending activities to users* A primary reason for supporting recognition over time of expected credit losses is that it more appropriately reflects the economics of the lending activity. For this reason, many constituents (including the Basel Committee and the EAP) agreed that expected losses should be recognized over the life of the assets. For a pool of financial assets, actual losses occur over the expected life of the pool; therefore, recognizing the expected credit losses over that expected life could provide a better matching of the timeframe over which losses occur. However, recognizing losses in the periods they actually occur during the expected life of the loans may not be achievable.

19. *No "Day 1" loss* Because this approach would allocate estimated expected credit losses over the expected life of financial assets, there would be no immediate charge to earnings. Allocating losses would mitigate the concerns of many that immediate recognition would have significant implications on the required capital that an entity is required to maintain for regulatory purposes.

Further, this treatment is consistent with the accounting for depreciable non-financial assets. In the case of depreciable non-financial assets, an expectation of loss is made on day 1 (for example, cost less salvage value) and that loss amount is allocated over the expected life of that asset (that is, depreciated). It would be inappropriate to record the entire expected loss (that is, the depreciable amount) immediately. Some believe there is no conceptual reason for treating financial assets differently from depreciable non-financial assets in this context.

Cons

20. *Concern about deferring losses* Some, including U.S. Banking Regulators, have expressed concern that an approach that would recognize expected credit losses over time would result in deferring losses for recognition in future periods. Constituents that have expressed support for an approach that would recognize expected credit losses over time have generally also supported imposing a minimum "floor" amount to ensure that the allowance would not fall below some minimum acceptable level. Such concern of deferring credit losses may be eliminated when the model complements allocation of expected credit losses with immediate recognition of changes in certain expectations, even when recognizing other expected losses over the life. In such an approach (for example, good book / bad book), the floor could be represented by the bad book.

21. *Potential operational complexity* Some are concerned that an allocation approach would be operationally complex. For example, the potential need to impose a floor amount or a bad book approach in order to ensure a minimum level of the allowance would seem to increase the operational complexity of an allocation approach (these issues are discussed further in the next section on additional issues to consider). In addition, an allocation approach in an open portfolio presents operational considerations. In addition to the expected life of the portfolio, which should be readily available information, entities would also need to calculate the weighted average age of the portfolio so as to know at what point the portfolio is at each assessment date, which would involve tracking

origination patterns and other data. (This issue is discussed further in the sections below.) Many constituents that supported exploring an allocation approach indicated that the methodology would need to be field tested to determine if it is operationally feasible.

Additional Issues to Consider

22. A model that would involve recognizing expected credit losses over time requires addressing the following issues:

    (a) Issue 1: What methodology should be used to allocate the credit losses over the specified timeframe?

    (b) Issue 2: Within an allocation model, when should immediate recognition of credit losses be required?

Issue 1: Methodology for allocation

23. In a decoupled model that recognizes losses over time, an approach would need to be selected for how and when to recognize expected losses. Remember that in an open portfolio, it is not possible to distinguish between new assets and existing assets. So, expected loss estimates include both initial estimates and subsequent changes in those estimates.

24. The timeframe for allocation of expected credit losses is discussed in Agenda Paper 1B / Memorandum 69. While there are several possibilities for selecting a timeframe for allocating the credit loss estimate, the staff believes that under an allocation approach the losses should be allocated over the same time period used for estimating the losses.

25. In a model that recognizes losses over time, the Boards would need to select a methodology for allocating those losses over the selected time period. As discussed in the October 5, 2010 IASB Agenda Paper 3, the idea of using a decoupled approach relates to keeping the effective interest rate calculation (as in

current IAS 39) separate from an expected loss estimate and its recognition. The IASB Exposure Draft, *Amortised Cost and Impairment* (IASB ED), proposed to calculate an effective interest rate by 'coupling' the expected loss estimate into that rate calculation. Therefore, a 'decoupled' approach removes that 'coupling' and keeps the effective interest rate calculation as it is today (which excludes the estimate of credit losses). The objective of the methodology would be to approximate the timing and amount of credit losses that would be realized.

26. The October 5, 2010 IASB Agenda Paper 3 discussed two possible alternatives:

    (a) Straight line approach—expected credit losses would be allocated evenly over the average life of the portfolio. The estimate of expected credit losses could be based on undiscounted amounts.

    (b) "Annuity" approach—expected credit losses would be estimated using a discounted cash flow calculation to determine the present value of the expected loss estimate; the result would be converted into an annuity, which would be allocated over the weighted average life of the portfolio and recognized in profit or loss as a periodic charge (including the notional interest related to an annuity).

27. Under the annuity approach, the selection of the discount rate is important because it influences how well the approach would approximate a credit-adjusted effective interest rate and whether the allocation of credit losses would align with the recognition of interest income. To perfectly mimic the effect of a credit-adjusted effective interest rate, the effective interest rate as defined in the IASB ED would need to be used to develop the annuity.

28. Regardless of which allocation approach is selected, there are special considerations when applying an allocation approach to an open pool of loans. To allocate expected losses, entities would need the following information:

    (a) The expected loss estimate for the pool

    (b) The expected life of the pool

(c) The weighted average age of the pool at the reporting date.

29. Because an open pool of loans is fluid in terms of adding newly originated loans and loans maturing on an ongoing basis, there is no beginning date and ending date as there would be in a closed portfolio. Therefore, while in a closed portfolio, the allocation would be based on the full expected life of the pool, in an open portfolio setting, the staff believes the allocation would be based on the weighted average age of the pool. As such, the approach requires determining the weighted average age of the pool at any given point in time, and entities will need to track the level of activity in the pool to obtain this information.

30. The result is that under this approach, in an open pool setting, the allowance balance would represent a *time-proportionate amount* of expected credit losses, as opposed to 100 percent of the expected losses.

31. To illustrate, assume for an open pool of residential loans, the expected life is ten years. The weighted average age of the pool of loans, at any given time, will be between zero and ten years. Assume that the weighted average age of a pool of loans within an open pool at a given point in time is five years (note that the expected life is ten years). Assuming no growth or decline in originations, the weighted average age would always remain at five years. Unless originations of loans in the pool cease, the weighted average age of a pool of loans in an open pool will never reach the point of the expected life.

32. Consider the following example. This example illustrates an open portfolio. However, for simplicity, the number of loans and the balance of the portfolio would be the same at the end of each period; that is, it assumes that no growth or decline in the origination of loans has occurred, resulting in the total balance of the portfolio and the weighted average age of the loans remaining constant. For simplicity purposes, it is assumed that the allocation method is straight line.

33. Assume a homogenous pool of 10,000 consumer loans with an expected life of ten years and a weighted average age of two years at any given time. Assume that the balance of the loan portfolio, before adjustment for credit losses, is

$1,000,000. The expected losses on the portfolio remain constant at two percent of the $1,000,000, or $20,000. Under a straight-line allocation method, the total expected losses of $20,000 would result in an allocation of $2,000 per year. When the weighted average age of the pool is 2 years, the allowance for credit losses would be $4,000, which represents the time-proportionate amount of 20% (2 years weighted average age / 10 years expected life) of total expected losses of $20,000. Under the assumption above that no growth or decline in the portfolio has occurred, the allowance for losses would remain constant at $4,000 at any given reporting period (given that the weighted average age also remains at 2 years). Therefore, increases or decreases in the allowance amount, absent a change in economic events or circumstances, will solely relate to a change in the weighted average age of the pool, which drives off of the rate of growth or decline in originations to the portfolio.

34. However, when losses are recognized (as expected, for example), the entity would first deplete the allowance balance and then build back up to $4,000. So, although the balance sheet amount remains at $4,000, profit or loss will not go unaffected. The amount necessary to ensure that the allowance balance represents a time-proportionate amount of total expected losses (after writing off loans against the allowance in the current period) will be recognized in profit or loss. (The staff notes that although this paragraph mentions the write off of loans, the Boards have not yet discussed recognition of actual losses.)

35. The staff points out that in an open pool setting, the allowance balance would not represent all of the expected losses at any point in time. In the example above, in a steady state environment, the reserve could never be more than the $4,000. If originations outpace maturities (growth), two things will happen: the weighted average age of the portfolio decreases and the level of the portfolio balance increases (presumably, depending upon level of new originations and the relative size of the new loans originated as compared to the loans maturing). An increase in portfolio balance will drive an increase in the total expected loss but will also drive a decrease in the weighted average age thereby possibly decreasing reserves.

Whether allowance increases or decreases on an overall basis in a period of growth will depend upon the relative decrease in weighted average age versus the level of the increase in the portfolio balance.

Issue 2: In an allocation model, when should immediate recognition of credit losses be required?

36. The question of whether, and if so when, immediate recognition of credit losses should be required needs to be addressed in an allocation model for two reasons. First, it is raised when considering what type of approach would be used to recognize changes in expected loss estimates (which include both initial estimates and subsequent changes in an open portfolio). Second, a question is whether the model would require immediate recognition of credit losses in certain circumstances based on a triggering event. Each of these issues is further discussed in the paragraphs below.

Changes in expected loss estimates

37. The IASB ED proposed that the allocation of initial expected loss estimates would be held constant by applying the same EIR throughout the life (excluding variable rate instruments). The effects of subsequent changes in those estimates were to be immediately recognized in current period earnings. This has been described as a full catch-up approach because the full effects of changes in the estimate of expected credit losses would be recognized in the current period.

38. Agenda Paper 3 explained that this approach is not operational for open portfolios, unless significant costs are incurred. Again, the reason that this was deemed not operational for open portfolios is that in an open portfolio, an expected loss estimate is made for the assets in the portfolio at a particular assessment date. This estimate actually consists of the initial estimate of expected losses on new assets in the portfolio and changes in the estimate of expected losses for existing assets. However, differentiating between what would be considered an initial credit loss estimate (which would be allocated) and a change

in estimate for existing assets in the portfolio (which would be recognized in the current period) would require tracking and maintaining the initial expected loss estimates for each individual asset, which is not operationally feasible in an open portfolio setting. As a result, each expected loss estimate at the end of a period will likely include some portion of initial expected losses and some portion of changes to previous estimates. The single revised estimate (and, therefore initial and subsequent estimates) will be treated the same.

39. As a result, IASB Agenda Paper 3 (October 5, 2010) discussed a "partial" catch-up approach or a "no" catch-up approach as alternatives for recognizing changes in credit loss estimates for financial assets in open portfolios. Under the partial catch-up approach, in the period that the entity has a change in estimate, current period earnings would be adjusted for the amount that would have been recorded to date, as if the revised estimate of expected credit losses had been the initial estimate (after also taking into consideration any losses applied to the allowance). Under the partial catch-up approach, the allowance balance would be adjusted to be a life-to-date proportion of the total expected credit loss estimate (as such, this approach is also referred to as the "time proportionate" approach). Under the no catch-up approach, there is no adjustment to the allowance for prior periods but there is an adjustment for the current period (a single period). IASB Agenda Paper 3 discusses each approach using the straight line and annuity approaches and provides illustrations of each. At the October 18, 2010 IASB meeting, the IASB agreed to further consider the partial catch-up approach and the remainder of this discussion focuses on this approach.

40. Continuing the example in paragraph 31, assume that economic conditions change, and, although the loans are still performing, an entity now estimates that expected losses are three percent, or $30,000. Under the partial catch-up approach, if the revised estimate had been the original credit loss estimate, because the assumption is that the weighted average age is 2 years, the entity would have a target allowance balance of $6,000 ($30,000 X 2 / 10) rather than $4,000 of credit losses calculated in the paragraph 33. Therefore, the entity

would recognize an amount equal to the difference between the allowance balance previously recorded of $4,000 and the new target balance of $6,000 ($2,000 as an expense in current period).

41. Because recognition of the credit loss estimate in an open pool is based on a portfolio's weighted average age, in a steady state environment, the allowance balance for a pool of loans will remain constant based on the proportion of the weighted average age of the loans to the total expected life of the loans within the pool. As a result, this type of method raises the question of whether, and if so when, it would be appropriate to recognize certain credit losses immediately.

Requiring immediate recognition of certain credit losses

42. As discussed earlier, some that support an allocation approach also support imposing a minimum "floor" amount to ensure that the allowance would not fall below some minimum acceptable level. This may be addressed through the addition of another component to the model that would require immediate recognition of certain credit losses.

43. FASB Memorandum 66 for the October 21, 2010 joint education session included discussion of an alternative for timing of recognition of credit losses referred to as a "combination" approach, in which a component of the impairment loss would be allocated over the expected remaining life of the related loans and another component would be recognized immediately. One approach for implementing this is to leverage the way many financial institutions currently manage credit risk; that is, by separating loans for the impairment analysis between a performing ("good book") and a non-performing ("bad book").

44. Many financial institutions currently manage credit risk by separating loans for the impairment analysis between a performing ("good book") and a non-performing ("bad book"). The EAP asserted that loans in a bad book are typically managed more actively (and frequently on an individual basis) with more robust analysis performed to assess the collectability of cash flows associated with the loans. Conversely, the EAP asserted that the determination of losses for loans in

a good book is based on statistical analysis at a portfolio level, which could be leveraged to estimate expected losses expected to occur over the effective life of a pool of loans. The FASB staff was also made aware of this type of risk management practice during its outreach activities and comment letter responses to its proposed impairment guidance in the proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities: Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815).*

45. The EAP discussed how to integrate this type of risk management approach into an accounting model for recognizing expected credit losses. Under one approach discussed by the EAP, losses expected over the expected life of financial assets within the good book would be recognized over their expected life. When an asset within the good book is subsequently considered impaired, the asset would be transferred to the bad book and a loss on this asset would be recognized in total immediately. The estimated expected losses of the good book would be updated every reporting period and the revised expected credit losses would be recognized using the partial catch-up approach described above. As discussed in the section above, the amount of expected credit losses recognized in the partial catch-up approach would reflect the proportion of the weighted average age to the expected life of the portfolio. The estimated expected losses of the bad book would also be updated each period, and any changes in those expected losses would be recognized immediately. Therefore, the total amount of expected losses on loans in the bad book would be recognized in full.

46. There are two key issues to be resolved in developing such an approach, as follows:

    (a) *When* to transfer a loan from the good book to the bad book

    (b) *How much* of the allowance should be transferred with the transferred loan.

47. This approach would require transforming a risk management technique for managing nonperforming loans into an accounting rule for recognizing credit losses. The approach would require providing explicit guidance for when a loan would be transferred. Therefore, the first issue is how to establish parameters or triggers for removing a (subset of) loan(s) from a good book to be separately analyzed for impairment in a bad book, including the timing of the transfer. That is, such a model would need to articulate when a loan would be transferred from the good book to the bad book.

48. The staff notes that this issue of *"when"* to transfer a loan from one portfolio to another is a fundamental question that exists in any model that permits a pool technique to be used for recognition and measurement of credit impairment. That is, the issue of whether a particular loan or subset of loans within a larger pool is deviating from other loans in the pool in terms of its performance, whether a different technique would be required for measuring credit impairment losses and, if so, what that different technique is for those loans. This issue exists regardless of whether loss recognition is immediate or whether losses are recognized over time. However, the staff believes the issue becomes more important for the recognition and measurement of credit impairment when credit losses are recognized using an allocation methodology.

49. Ideally, this approach would differentiate between those changes in credit loss estimates that were expected for the pool and therefore built into the compensation received through the interest rates charged, and those loss estimates that are driven by an event or change in conditions that was not considered in the pricing of the loans. Depending on the nature of the loss estimate (in line with expectations or not), there may be a different view on whether the loss should be recognized immediately through transfer to the bad book under the premise that it is being compensated for the loss through the interest income that it receives under the loan arrangements. However, the staff is uncertain whether it is possible in practice to differentiate between changes in loss estimates that were

expected (and considered in the pricing) versus unexpected (and not considered in the pricing).

50. The staff believes there would be a need to develop some practical guidance around defining when a loan would be transferred from a good book into a bad book. Various possibilities that could be considered for establishing a trigger are the following:

    (a) Loans could be transferred when in default for a defined period (that is, non-performing).

    (b) Loans could be transferred prior to default when information suggests that it is likely they will default.

    (c) Loans could be transferred when management judgment deems it appropriate to transfer the loan from a good book to a bad book because of the significance of an event or change in conditions.

51. If non-performing status is selected as the trigger for transfer to a bad book, as in (a) above, the timing of identifying loans as non-performing could have a significant impact on credit loss recognition as the default rate and speed may occur over time at an unpredictable pace. An approach similar to (b) or (c) above would permit greater management judgment to apply in determining when a transfer should occur. Approach (c) above would require some guidance for determining that an event is significant in nature and will likely result in an entity experiencing significantly more credit losses (or, conversely, is not sufficient for immediate recognition before loans are identified as non-performing).

52. Regardless of the parameters or triggering events that require a transfer, when it is deemed necessary that a particular loan be transferred from a good book to a bad book, a second key issue is "*how much"* of the allowance would be transferred from the good book to the bad book. For example, the total allowance needed could be transferred from the good book. In this case, management would have to determine whether the magnitude and timing of the loss impacts its existing allowance balance. In other words, the good book allowance may require an

increase or decrease. Alternatively, the allowance transferred from the good book could be only the proportionate amount attributable to that loan with a catch-up to the loan when it is in the bad book recognized immediately. The staff believes that under either approach, the resulting allowance should be adequate on an overall basis when combining the allowances attributable to the good book and the bad book.

53. The feedback received by the FASB from its constituents who advocated advancing the analysis of this approach was requests to better develop the approach as constituents had not yet had the opportunity to determine whether the approach was operational or would provide adequate reserves needed to cover losses that it expects to occur within a reasonable future period. The IASB also received feedback that constituents would like the opportunity to evaluate and comment on any approach developed as a result of the EAP meetings and other outreach.

Financial Statement Presentation under the Alternatives

54. While presentation matters have not been specifically discussed, the following presumes that, for presentation purposes, the allowance for credit losses will be presented separately from the financial assets to which they relate in the statement of financial position.

Immediate Recognition

55. From a balance sheet perspective, under this alternative, the allowance for credit losses would represent the amount of credit losses at the reporting date that management believes is inherent in its financial asset balance (for example, funded loans or debt securities) based on the information considered and the amount that the estimate is designed to capture (that is, this can be an estimate of all expected losses on the financial assets regardless of when they might occur or

a portion of expected losses, such as losses expected to occur over the foreseeable future).

56. Under this alternative, the allowance could not carry a negative balance. The amount of the change in losses expected to occur that can be recognized is bounded by the existing balance of the allowance for credit losses. That is, a change in expectations could not result in reversing credit impairment unless it was previously recognized as a charge in net income. Based on this description of the allowance, the carrying amount of the financial assets would represent management's best estimate of cash flows that will be realized for the financial assets.

57. From an income statement perspective, in each reporting period, the income statement would include an expense that fully reflects changes in the credit loss expectations. Changes in expectations can be driven by changes in portfolio balances, portfolio composition, events and conditions that affect the performance of the existing financial assets, changes in factors considered in developing historical loss rates or cash flow estimates, changes in economic conditions, and changes in expectations with respect to forecasted events and economic conditions, to the extent they are permitted to be considered in the impairment analysis.

Recognition over time

58. In an approach that allocates the initial estimate of expected credit losses, the allowance is built up over time through the recognition in current period earnings of the amount of expected credit losses (both initial and changes in estimates) apportioned to the current period. The intent is to adjust the allowance for an amount that closely approximates the difference between the contractual yield on financial assets and credit-adjusted yield, which is the fully integrated approach proposed in the IASB ED.

59. Under a decoupled approach, the amounts presented in the financial statements (both the allowance and current period earnings) will depend on the treatment of expected loss estimates. IASB Staff Paper 9B (week of October 18, 2010) discussed the financial statement impact of the various alternatives for recognizing change in expected credit losses. For ease of reference, these are summarized below.

60. Under the partial catch-up approach, at each reporting date, the allowance represents the portion of the expected loss estimate for the financial assets that corresponds to the current point in time during the expected life of the financial assets. The amount reflected in the balance sheet under this approach would be the present value of all expected cash flows (excluding expected credit losses) less the existing allowance for credit losses. The remaining expected credit losses would not be reflected on the balance sheet. The amount recognized in earnings (other than the interest income related to the calculation of the original EIR by the carrying value which reflects the effects of all event arising in current reporting period, excluding effects of any credit events) in each period is the amount needed to reach the apportioned amount of expected credit losses that is reflected in the allowance.

61. Under a combination approach described as the good book/bad book approach in this paper, the overall allowance will represent the sum of the following components:

    (a) The built-up amount of the allowance related to the good book, effected through the recognition in current period earnings of the amount of expected credit losses (both initial and changes in estimates) apportioned to the current period, and

    (b) Any incremental allowance required to be established due to a transfer for the immediate recognition of credit losses based on a trigger that required a transfer from the good book to the bad book.

62. In a combination approach the timing of transfers from one portfolio to another, triggering immediate recognition of credit losses, will affect the adequacy of reserves and directly impacts whether the objective of having adequate reserves at any given point in an economic cycle is met. Depending on the trigger used (for example, if the trigger is a default), some may view this as deferring the recognition of credit losses until the loans are actually identified and therefore reserves may be considered to be too low at various points in the economic cycle.

Staff Analysis

63. The staff believes that the approaches in the FASB ED and IASB ED had different objectives and each model recognized credit losses using the recognition pattern that fit within that overall objective.

64. The FASB ED proposed immediate recognition of credit losses based on the view that the allowance for credit losses should reflect the amount of credit losses that management expects at the reporting date based on the assumption that current conditions persist for the life of the assets.

65. The IASB ED's objective related to the measurement of amortized cost, with credit impairment an integral part of that amortised cost measurement. That is, the proposed definition of amortised cost measurement was the present value of all expected cash flows discounted at the internal rate of return calculated for the initially expected cash flows, including initially expected credit losses. Using this net present value measurement, recognition of initially expected credit losses would occur over the same timeframe as interest revenue for the financial assets. The proposal required the effects of subsequent changes in those estimates to be recognized immediately to ensure recording of the change in estimate in the period that change occurred, hence ensuring that the carrying amount (present value of expected cash flows) always unwinds to the expected cash flows.

66. After analysis of constituent feedback and significant outreach activities, many issues have been identified within each model, and there have been differing

views expressed on the timing of recognition of credit losses. Some, including certain preparers, some U.S. users of financial statements, and the U.S. Banking Regulators, believe that immediate recognition of expected credit losses results in establishing the appropriate reserve for credit losses on the balance sheet. However, many others, including many user groups and non-U.S. users, believe that it is appropriate to reflect the economics of the lending activity using the net present value (amortised cost) approach proposed by the IASB which results in matching the revenue and expense associated with the financial assets, to the extent possible (see next paragraph discussion). Most advocated further exploration of an operationally easier allocation approach.

67. With respect to an approach that recognizes credit losses over time, one major hurdle is that, in an open portfolio setting, there is an inability (operationally without incurring significant implementation costs) to differentiate between existing loans and new loans. Therefore, on an open pool (portfolio) basis, revised estimates will include both "initial" estimates for new assets and some "changes" in estimates for assets that have been in the portfolio for some time. The issue then becomes how to account for these revised estimates and get the same, or similar, outcome as if you could separate the initial expectation from the subsequent changes in those expectations.

68. If we try to mimic the outcomes of the IASB ED (that is, allocating an initial credit loss estimate on a new loan and immediately recognizing a change in credit loss estimate on an existing loan) while making it operationally easier, some compromises would be required. For example, the staff believes that in any approach involving allocation, there will be a need to immediately recognize some portion of credit loss estimates in order to capture, at least, some of a change in estimate. But, because a revised expected loss estimate would also include "initial" expectations, recognizing the entire amount immediately does not achieve the IASB's original objective. The immediate recognition of the revised estimate could be done through a partial catch-up, establishing a

minimum floor amount for the allowance, or through transfers to the bad book in a combination approach.

69. Any such compromises for operational reasons move away, to some extent, from the original objective of amortized cost measurement (i.e. net present value of all expected cash flows - which results in the matching of credit losses and related interest revenue for the initial expected losses and recognizing changes in estimates in the correct period).

70. Focusing on operationality of the alternative approaches, the staff believes that an immediate recognition approach is operationally less complex. The earlier section in this paper on additional issues to consider in developing a decoupled approach for allocation of credit losses highlights various operational issues and potential complexities of an allocation approach. Some constituents have questioned whether the level of complexity is warranted, especially if the outcome of a developed approach would not achieve similar results to the original objective of amortized cost measurement.

71. Some have indicated that in a "steady state" environment, when loans are added and removed to a pool at a similar rate, the effects of an immediate recognition model and some allocation models might approximate one another.

Question for the Boards

72. Under either approach, the staff believes there are additional issues to be considered. If the Boards select Alternative 1 (immediate recognition), then the staff believes there is a need to consider how credit losses will be measured. This would require a consideration of when credit losses would be measured using a pool technique or an individual asset technique, or whether both would be permitted. In addition, the Boards would need to address whether credit losses will be estimated using historical loss rates, present values of expected cash flows, or a combination (potentially depending on the unit of account). Further, as

previously discussed, there would be a need to address whether, and if so when, entities would be required to remove individual financial assets from a pool.

73. If the Boards select Alternative 2 (recognition over time), then the Boards will need to consider the issues outlined in the previous paragraph as well as the issues described in this staff paper in the section discussing additional issues to be considered.

74. Depending on the alternative selected, the staff would need to perform further analysis of those issues.

Question for the Boards
Which alternative does the Board support for timing of recognition of expected credit losses? Alternative 1: Immediate recognition of expected credit losses Alternative 2: Recognition over time