IFRS
FASB

Financial Instruments Working Group Meeting

Agenda paper	Date	**5 August 2011**

Project	**Financial instruments: Impairment**
Topic	**Initial feedback summary**

Introduction

1. On 1-2 August, members of the IASB and FASB as well as staff attended a meeting with various credit risk managers from banks around the globe in order to get initial feedback on the current thinking of the 'three-bucket' approach. As a reminder, the current thinking incorporates a credit risk management approach to reflect the general pattern of deterioration or improvement in the credit quality of financial assets.

2. The following points are the key take-aways from that meeting. The staff intends to write a more comprehensive paper to present at a future board meeting.

Overall

3. Strong support for a model that attempts to align with current credit risk management practices

4. There was not a lot of concern expressed about the ability to apply this model to different asset classes, provided that the definition of the buckets was not solely based on probability of default (PD). In other words, the definition could contain reference to other characteristics so that entities that did not calculate PDs for every asset class would be able to consistently apply the model. In particular, they indicated that the model should also work for debt securities – they did not foresee particular issues with this. The operationality of this approach for debt securities held by nonfinancial institutions was not explored.

Approach to Bucketing

5.   There was support for an approach that would allocate loans[1] to the buckets based on the absolute credit quality of the loans. For example, commercial loans of quality AAA- X would be in Bucket 1, X-XX would be in Bucket 2, XX-XXX would be in Bucket 3.

6.   The discussion revolved around what would be an appropriate threshold of credit quality for the buckets. Some suggestions:

    a.   PD levels (ie create 3 PD bands for the buckets)

    b.   US Regulatory definitions (for example, special mention, substandard)

    c.   Investment grade versus non-investment grade status (external and internal ratings)

    d.   For retail loans, delinquency status augmented by factors such as loan to value ratios, credit scores, or some combination of those

7.   Strong support for setting the threshold between buckets based on PD levels. However, to make the model operational for most entities, the guidance should express the threshold qualitatively (a 'characteristics-based' approach rather than based on PDs) with grounding in risk management practices. Preliminary characteristics discussed mirrored that used by US Banking Regulators for 'special mention' or 'substandard categories,' which build in concepts of likelihood of default and amounts of expected losses.

Initial Bucket Classification

8.   A characteristics-based model as outlined above works well in a pure absolute model where all loans would be initially classified based on their characteristics but not for a model that would require all loans to be initially allocated to Bucket 1. That is, it is more difficult in such an approach to accommodate loans originated/purchased with credit quality consistent with the characteristics of assets that would be assigned to Bucket 2.

---

[1] The term 'loan' is applied as short hand for financial assets.

9. Operational challenges were identified with an approach that has all assets originated/purchased into Bucket 1 and subsequently reclassified based on some level of credit deterioration:

    a. To properly apply this model it would be necessary to compare the initial loss expectations with loss expectations over time. This potentially introduces significant tracking/operational issues.

10. Some, therefore, suggested model should be based on absolute levels of credit risk as this is more in line with credit risk management practices

11. They felt that all banks would have systems that incorporate such a grading/ranking notion at some level that could be used as a basis for such an impairment accounting regime.

12. Some concern was expressed than an absolute model recognises lifetime day-1 losses for higher risk assets issued/purchased, even if priced for that risk.

13. There is a trade-off between accepting a day-1 loss or having the complexity of tracking information.

14. A 'relative overlay' to the absolute model was discussed:

    a. For example, assets originated/purchased into Bucket 2 would be separately tracked until deterioration occurs and remaining lifetime expected losses are then recognised

15. Even that relative overlay would require tracking of the original loss expectations; while tracking from inception was expressed as difficult, it could be made operational.

    a. Suggested simplification: When ANY deterioration on the purchased/originated asset occurs, no longer need to monitor deterioration from original loss expectations. Allowance on that asset(s) measured consistently with assets of like credit quality.

    b. Simplification not unanimously supported. Infrastructure for tracking the assets even for one period would have to be established. Cost/benefit?

Transfers Between Buckets

16. In the context of the absolute model discussed, when the credit quality changes to a level consistent with another bucket, loans would be transferred.

17. The lower the threshold between Buckets 1 and 2, the greater the 'cliff effect' of then recognising lifetime expected losses upon transfer. Loss rates increase at a higher pace in the lower quality ratings.

18. It was noted that providing 'indicators/cues' for when to transfer between Buckets 1 and 2 may not be the most helpful way of describing the split because credit quality is based on a matrix of indicators and cues. All of that information is assessed together to calculate a credit quality.

19. Because the definition of the buckets during the discussions might relate to an absolute level of credit risk, or delinquency status for retail loans, for example, a lot of the analysis of transferring between Buckets may be done on an asset-by-asset basis even for retail portfolios.

Measurement

20. The staff clarified that remaining lifetime expected losses is meant to capture the present value of all expected shortfalls in cash flows (ie both principal and interest cash flows).

21. Also, the attendees confirmed their belief that the measurement of credit impairment losses in Buckets 1 and 2 could be based on an individual instrument unit of account or on a pooled basis.

22. There was a preference for measurement of credit impairment losses for assets classified in Bucket 1 based on losses expected in 12-months as most banks already have 12-month data and this aligns with;

    a. Risk management practices

    b. Some regulatory requirements

    c. Financial reporting period / budgeting

23. However, measurement of credit impairment losses based on losses expected in a 24 month time period for Bucket 1 would not create significant operational issues.

24. There was a view expressed by some that in comparison to the incurred loss model, the allowance for loan losses would be significantly higher under the proposed approach. They believed most of the difference would come from the allowance for loss in Bucket 2 because Bucket 1 would by definition have a very low probability of default.

25. Although Buckets 2 and 3 would both be measured using the remaining lifetime expected losses, there was a widely held view that Buckets 2 and 3 should remain separate. This was because they viewed Bucket 3 as having a PD of (close to) 100%, with very little chance (if any) of moving back out of Bucket 3. And, in addition, Bucket 3 would always be individually identified loans, whereas Bucket 2 could be either a pool or individual loans.

26. There was a discussion of differences between the Basel II calculations based on 1 year expected loss for regulatory capital purposes and use of a 12-month expected loss measure for impairment accounting purposes. For example:

    a. Basel II parameters are through-the-cycle where an entity looks back through the cycle to determine what will happen, but would not adjust for forward looking data

    b. Basel II framework requires the downturn of 'loss given default' (LGDs), whereas expected losses would incorporate expectations of future (downturn or upturn)

    c. Basel II parameters have floors that would be removed for accounting purposes

    d. Basel II definition of default (for the purposes of determining LGD, or loss given default) may differ from the accounting definition; therefore it is important to provide a clear definition of 'default'.

Disclosures

27. Related to disclosures, the information provided should be balanced with the operational effort to produce the disclosure and the volume of information to be included in the financial statements.

28. It was suggested that consideration be given to Pillar 3 disclosure requirements mandated by Basel III in developing disclosures related to the impairment model.