



Agenda paper

Date 5 August
2011

Project	Financial instruments: Impairment
Topic	Credit risk management approach

Purpose of this paper

1. This paper seeks your feedback on the credit risk management approach currently being considered for the impairment model for financial assets.
2. This paper contains summary background information on the impairment project, and specific questions for you. Appendices A-D (distributed as separate documents) include relevant reference materials you may find useful.

Background

3. The comment period for the joint supplementary document *Financial Instruments: Impairment (SD)* – a supplement to the original exposure drafts (original EDs) which addressed the impairment of financial assets¹ – ended 1 April 2011. One message that has been consistently received, regardless of jurisdiction or type of respondent, is that there should be a converged solution for impairment. Many believe that for the financial instruments project the most important part on which to reach a converged solution is impairment.
4. However, the boards did not receive strong support for the proposals in the SD. As discussed in the comment letter summary², most of the feedback on the SD approach was consistent across jurisdictions in the issues and concerns that were raised, but were different in the suggested solutions to address those issues and concerns.

¹ The original IASB ED *Financial Instruments: Amortised Cost and Impairment* (original IASB ED), was issued in November 2009. The FASB Proposed Accounting Standard Update *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* (original FASB ED) was issued in May 2010, and included proposals for the impairment of financial assets.

² See Appendix A, IASB agenda paper 4D / FASB Memo 86 of the week of 5 April board meeting.

5. Using those comments received, as well as feedback from outreach activities, the boards created a small internal working group to begin to develop an approach that would be a variation on the previous proposals. In the June 2011 joint board meeting³, the boards decided to develop a ‘three-bucket’ expected loss approach for the impairment of financial assets. The guiding principle of the ‘three-bucket’ approach is to reflect the general pattern of the deterioration of credit quality of loans. The different phases of the deterioration in credit quality are captured through the ‘three buckets’ that determine the allowance balance for financial assets subject to impairment accounting.
6. In the July 2011 meeting⁴, the staff presented to the board possible approaches to determine how assets are allocated to each bucket and when assets are transferred between Buckets 1, 2, and 3. The boards agreed that the ‘three-bucket’ approach should reflect the credit deterioration or improvement in loans making maximum use of credit risk management practices.
7. In July, the boards also decided that the allowance balance in Bucket 1 would be based on the losses expected to occur either over the next 12 or 24 months (a decision on either 12 or 24 months would be made in a future meeting after the staff completes more outreach and can provide a recommendation)⁵.
8. The next section describes the current thinking of a credit risk management impairment model. However, before moving to the description, it is important to note that the June meeting described a ‘three-bucket’ approach that would consist of pools of loans in both Buckets 1 and 2. Then, once a loan was individually identified as impaired, it would be moved to Bucket 3. At the July meeting the boards have moved to a credit risk management approach focusing on deterioration in credit quality. Under this approach it is envisaged that, unlike the approach discussed in June, it may no longer be necessary to restrict Bucket 2 to portfolios. Following a credit risk approach, the analysis in Buckets 1 and 2 could be based on an individual basis or on a pooled basis. In other words, a specifically identified medium risk loan (that may not be impaired yet) could be included in Bucket 2 (or if just originated, in Bucket 1). As a result, and

³ See Appendix B, IASB Agenda Paper 8 / FASB Memo 99 of the June 2011 joint board meeting.

⁴ See Appendix C, IASB Agenda Paper 7A / FASB Memo 100 of the July 2011 joint board meeting.

⁵ See Appendix D, IASB Agenda Paper 7B / FASB Memo 101 of the July 2011 joint board meeting.

because the allowance in Buckets 2 and 3 are measured using the losses expected to occur over the remaining life, consideration will need to be made as to whether Buckets 2 and 3 should remain separate or be combined.

Current thinking of credit risk management approach

9. The credit risk management approach would include a principle to reflect the general pattern of deterioration or improvement in the credit quality of financial assets, making maximum use of credit risk management practices. Such an approach is based on *changes* in credit risk, as opposed to the overall credit quality of the assets. It seeks to be responsive to changes in information that have an effect on the credit quality of financial assets. This approach would result in the movement of loans between buckets depending on changes in credit loss expectations.
10. Under this approach, all originated and purchased financial assets⁶ would initially start in Bucket 1. The assets would be subsequently categorised into Buckets 2 or 3 when credit loss expectations deteriorate sufficiently, affecting the uncertainty in collectability of cash flows. Because all originated and purchased financial assets are initially in Bucket 1, it will comprise financial assets with varying credit qualities. The allowance balance for this bucket will be determined taking into account the different loss expectations for these assets with varying credit qualities in the bucket. In other words, higher risk loans in this bucket will have a higher 12 or 24 month expected loss than lower risk loans in the same bucket.
11. The preliminary thinking on the principle to transfer assets between buckets is as follows:

Financial assets are required to migrate from Bucket 1 into Bucket 2 if, based on all reasonable and supportable information:

- (1) a deterioration in the financial performance of the borrower (s) is expected which leads to

⁶ It is noted that the boards earlier decided to adjust the effective interest rate for purchased loans acquired at a deep discount due to credit losses to reflect the initial credit loss expectations. Because the effective interest rate is calculated differently than for all other financial assets subject to impairment accounting, those loans will be considered separately. As a result, the discussions at the FIWG meeting should focus on loans that are performing at the time of origination or purchase.

- (2) an increase in uncertainty about the ability to fully recover cash flows. That increase in uncertainty is based on it being more likely than not.

Financial assets are required to migrate into Bucket 3 if, based on all reasonable and supportable information:

- (1) the financial performance of the borrower further deteriorates which leads to
- (2) expected non-recoverability of cash flows identified for individual assets.⁷

12. It is important to note that under this model, it is not proposed that deterioration in credit quality would be tracked from origination. Rather the tentative approach proposes that an entity would determine if deterioration had occurred since the last period to such an extent that a transfer to Bucket 2 or 3 is now warranted⁸. For example, if a loan was issued on 1 January 2005, for purposes of determining the credit deterioration for the quarter ended 31 December 2010, an entity would only need to look at the credit quality of the asset at 30 September 2010. The credit quality at 1 January 2005 (or any of the other quarters between) is not relevant to determine the deterioration in credit quality for the current reporting period.⁹
13. The measurement of the allowance balance for Buckets 2 and 3 would be an entity's estimate of remaining lifetime expected losses.
14. For Bucket 1, the allowance balance would be losses expected to occur either over the 12 or 24 months after an entity's reporting date. (Please note that the Boards did not choose between these two periods and directed the staff to explore both). Specifically, Bucket 1 would be based on an '*annual*' rather than an '*annualised*' loss rate (that is, looking to the losses that are expected to occur in the next 12 months/24 months, as opposed to calculating the lifetime losses and dividing by the number of years remaining).
15. The expected credit losses for the allowance balances in all buckets shall be based on both historical and current information including forward looking information. If credit loss expectations change within a single bucket (ie the

⁷ These principles have not been discussed by the boards and are included only as a basis for discussion.

⁸ A key question is how much deterioration needs to occur to cause a transfer and how best to operationalise this.

⁹ Our initial outreach with a small group of credit risk managers have confirmed that this sort of tracking could be performed. Currently, we are performing additional outreach with a wider group of credit risk managers on whether this sort of tracking can be performed, and whether the credit impairment model could be applied in this manner.

principle for transferring the asset has not yet been met), then that changes the allowance balance calculations in that bucket. Each period, the allowance balance for each bucket needs to be adjusted based on updated loss expectations.

Considerations

16. Only the framework for development has been agreed so far and additional issues still need to be considered. For example, as mentioned, Bucket 1 will include loans of varying credit quality. As a result, disclosures may need to be developed in order to provide information about the ‘absolute’ credit quality of loans in the buckets.
17. In addition, identifying how much deterioration needs to occur from period to period in order to transfer the assets out of Bucket 1 may be challenging. One way of doing this might be to describe a principle identifying the point at which it is appropriate to recognise full remaining lifetime expected losses.
18. For any impairment model, another consideration is to identify to what extent a single model can be applied to all types of instruments: revolvers, trade receivables, debt securities, individually significant loans, etc. In addition, to what extent can the same principles be applied to consumer and commercial loans.
19. As mentioned above, because the model is based on deterioration in credit quality, having three buckets has been useful in considering deterioration of quality. However, full remaining lifetime losses are recognised for both Buckets 2 and 3, so ultimately it may not be necessary to have both Buckets 2 and 3. Rather, perhaps they could be combined.

Discussion questions

20. We are interested in getting your feedback on the following issues:
 - (a) Do you think a single impairment model should be developed for all financial instruments? If the model described above is

- further developed, do you think it could be used for all financial instruments?
- (b) Do you believe a principle to describe the transfer between buckets is necessary? If so, do you believe the principle described above is appropriate and can be applied? Or, what suggestions would you make to change it?
 - (c) Is it appropriate to link the credit impairment model to credit risk management practices, with a focus on deterioration? What suggestions would you have to address any non-comparability issues (eg loans with like credit qualities in different buckets)?
 - (d) Should all (non credit-impaired) purchased assets and originated assets be initially classified in Bucket 1? Or, are there circumstances that you believe warrant initial classification (with full lifetime loss) in Buckets 2 or 3?
 - (e) For Bucket 1, how much focus should we put on the question of the adequacy of the allowance balance? What are your thoughts on 12 months versus 24 months expected losses for the allowance balance of that bucket?
 - (f) What indicators/cues would you find helpful to apply the described model noting that it is important to the boards that the transfer to Bucket 2 is timely (ie occurs quickly when there is deterioration in credit quality which makes it appropriate to recognise full remaining lifetime losses immediately)? What additional application guidance would you find helpful?

List of Appendices

21. The following documents are provided separately as Appendices:
- (a) Appendix A: IASB Agenda Paper 4D / FASB Memo 86 of the April 2011 joint board meeting – Comment letter summary
 - (b) Appendix B: IASB Agenda Paper 8 / FASB Memo 99 of the June 2011 joint board meeting – Three-bucket approach

- (c) Appendix C: IASB Agenda Paper 7A / FASB Memo 100 of the July 2011 joint board meeting – Transfer between buckets
- (d) Appendix D: IASB Agenda Paper 7B / FASB Memo 101 of the July 2011 joint board meeting – Bucket 1 measurement