

# STAFF PAPER

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## Introduction

1. The Cover Paper, IASB Agenda Paper 6 / FASB Memorandum 117, provides a brief background to the topics addressed in this paper.
2. This paper addresses two main topics:
  - (a) **Topic 1:** The **objective** of the allowance balance in Bucket 1. The staff have identified the following alternatives for an objective:
    - (i) Alternative 1 – approximating a yield adjustment
    - (ii) Alternative 2 – capture as the allowance balance expected losses which have not yet materialised (ie on which no meaningful deterioration has occurred) (EBNM) on assets in Bucket 1.
  - (b) **Topic 2:** The **measurement** attribute of the allowance balance in Bucket 1. In response to the joint board discussion in October and using feedback from outreach activities, the staff have identified the following alternatives for the measurement of the allowance balance in Bucket 1:

- (i) Alternative A – shortfalls<sup>1</sup> in cash flows expected to materialise in the next 12 months
  - (ii) Alternative B – shortfalls in cash flows expected to materialise in the next 24 months
  - (iii) Alternative C – shortfalls in cash flows expected to materialise over an emergence period as defined by one of the sub-alternatives below:
    - 1. Alternative C1 – No defining boundaries for the emergence period. Entities would consider all reasonable and supportable information available, including historical information in order to determine the appropriate emergence period expected for each asset class.
    - 2. Alternative C2 – A minimum of 12 months is established with no upper boundary.
    - 3. Alternative C3 – Defining a range for an emergence period (eg between 12 and 24 months).
3. The discussions related to the objective and measurement of Bucket 1 to date have largely been focused on commercial assets. As other instruments are discussed (eg retail loans, other receivables, publicly tradable debt securities, etc) the staff will need to consider how the analysis below would apply to such instruments.

## Topic 1 – Objective of Bucket 1 Allowance Balance

### ***Alternative 1 – approximating a yield adjustment***

4. This alternative would have an objective of recognising expected credit losses over the time periods in which interest revenue is recognised for assets in Bucket 1 (ie a yield adjustment).

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<sup>1</sup> These alternatives would recognise shortfalls in **all** cash flows (ie lifetime) expected to materialise in the next 12 or 24 months ( using a 12 or 24 month probability of default notion), not just the shortfalls in the cash flows for the next 12 or 24 months (ie the cash not expected to be collected in the next 12 or 24 months)

5. This alternative is similar to the objective of amortised cost measurement in the IASB's original exposure draft. The objective in that document was 'to provide information about the effective return on a financial asset or financial liability by allocating interest revenue or interest expense over the expected life of the financial instrument'.
6. A true yield adjustment would be similar to the integrated effective interest rate described in the 2009 IASB Exposure Draft, *Financial Instruments: Amortised Cost and Impairment*. That integrated rate was the discount rate that results in a present value of the expected cash flows that equals the carrying amount of the financial asset. The calculation of the integrated effective interest rate took into consideration the timing of expected cash flows. Then, the calculated rate was applied over the life of the asset so as to build up the allowance (thereby also recognising losses) over the life of the asset. This effective interest rate was not trying to match the actual expected losses in each accounting period to the interest collected that accounting period. The IASB noted the operational complexities of determining a true yield adjustment (ie an integrated effective interest rate), and therefore decided to 'decouple' the interest rate at the 15 September 2010 meeting.
7. The staff notes that this paper only addresses the objective of the Bucket 1 allowance balance, and the IASB original exposure draft was addressing the objective of the amortised cost measurement, in total. The IASB original exposure draft would have immediately recognised the full effect of any changes in expected loss estimates, and the original yield adjustment would continue to be applied to the instrument throughout its life. In a three-bucket approach, changes in the estimate are always reflected in the allowance balance (in full or part depending on the bucket). It is only in Bucket 1 where a yield concept could be applicable because full lifetime losses are recognised in Buckets 2 and Bucket 3. So the model cannot be a real proxy for the original IASB ED.
8. In developing a proposed financial reporting standard the boards shall consider the costs and benefits involved (see paragraphs QC35-QC39 of the IASB *Conceptual Framework for Financial Reporting* and FASB Statement of Financial Accounting Concepts No. 8). The boards have already discussed the

complexities of calculating an integrated effective interest rate, calculating interest revenue by including the impairment allowance in the calculation of interest revenue, and the resulting impact on the net interest margin (see IASB Agenda Paper 4A / FASB Memorandum 83 of the April 2010 joint meeting). As a result of the costs associated with applying a true yield adjustment, if a yield concept is to be incorporated it seems appropriate to consider a proxy for the yield adjustment (see measurement section below).

### *Advantages*

9. Conceptually, an objective related to a yield adjustment is based on the assumption that financial assets are priced so that the interest rate being charged compensates for the initial estimate of future expected credit losses (regardless of the expected loss pattern). Amortising the initial estimate of future expected credit losses over the life of the instrument avoids the systematic overstatement of interest revenue in periods before a loss event occurs.
10. Permitting a proxy of a yield adjustment is operationally simpler than requiring a true yield adjustment calculation.

### *Challenges*

11. The approach being considered is a balance sheet approach in that the allowance balance always reflects a [12 month, 24 month, emergence period] loss estimate on the balance of financial assets. The income statement, therefore, reflects the change in the allowance balance period over period. If losses crystallised as expected (and therefore the allowance balance is used up and then rebuilt), then the income statement would reflect a 'proxy' yield adjustment. However, if losses occur differently than expected, then the income statement may not reflect any adjustment (or very little). This means this approach is a poor proxy, at best, for a yield adjustment.
12. For example, an entity estimates it will lose 10 CU in the next 12 months (year 1) on its assets in Bucket 1. It has no assets in Buckets 2 or 3. During year 1, no losses crystallised (ie the expectations were incorrect). For year 2, the entity again estimates losing 10 CU in the following 12 months. This would have no

impact on the income statement because the allowance balance was already 10 CU, so the losses are not being recognised over the life as is the interest revenue (like a true yield adjustment). In other words, it may be difficult to approximate a yield adjustment no matter what measure is used for the allowance balance.

***Alternative 2 – EBNM (Expected but not materialised)***

13. This alternative would have an objective of recognising, as an allowance, the total amount of shortfalls in cash flows expected to materialise on financial assets for which there has been no meaningful deterioration in credit quality in the next [insert appropriate period – eg 12 months, 24 months, emergence period etc].
14. This alternative recognises that when evaluating Bucket 1 as a whole, the entity may expect losses on the assets, despite there having been no meaningful deterioration yet. In other words, this alternative recognises that there is a risk of loss on assets originated and purchased, so there is an expected loss in Bucket 1 – even though no meaningful deterioration has yet occurred.
15. Some have suggested that this approach could be applied by recognising no allowance until a credit deterioration event had occurred, and then making an estimate of losses expected to occur as a result of that credit deterioration (even though not specifically identified to individual assets). This would essentially reflect the fact that initial losses are priced into the asset. However, the staff notes that identifying that credit deterioration event would be just as difficult, and result in inconsistency in application, as the incurred loss events of today. Furthermore, if assets never deteriorated in credit quality, then no allowance would ever be recognised against them. So, if expected losses occur as originally expected, there would be no allowance resulting in overstatement of interest revenue in earlier periods and potentially large effects on the income statement in periods the losses occurred. Effectively, the problems we have today would be perpetuated, at least in part.

### *Advantages*

16. This approach builds on the current accounting models for impairment recognition. However, this is different, conceptually, from the incurred but not reported (IBNR) concept in IAS 39 impairment accounting which requires the occurrence of an event before recognising any impairment allowance. As a matter of fact, IAS 39.AG92 prohibits the recognition of an impairment loss on initial recognition of a financial asset. However, staff understands that some apply the IBNR notion under IAS 39, and the guidance in U.S. GAAP, in a manner that does have initial recognition of losses. In other words, upon the origination of an asset that is added to an open pool, an IBNR or a general provision is calculated. However, the loss rates applied in those scenarios do not use forward-looking information whereas an expected loss model would use all reasonable and supportable information, including forward-looking information.
17. This approach acknowledges that on the basis of historical experience, some losses will occur on assets even if they do not deteriorate post initial recognition. So, it creates an allowance balance for the expected losses on assets that have not yet had a meaningful deterioration.

### *Challenges*

18. The primary challenge of this approach is that a loss is recognised immediately upon origination essentially in anticipation of inherent losses. Although, the outcome of the first alternative (ie proxy to yield adjustment) is similar, the justification differs. Some believe that recognising a loss upon initial recognition is not a true representation of the economics of the transaction and question whether it is consistent with usual accounting concepts.

### ***Topic 1 – Staff recommendation and question to the boards***

19. The staff notes that because the measurement of the allowance will be based on expected losses, and a true yield adjustment is not being pursued by the boards, both alternatives would recognise an allowance upon initial recognition of the financial asset.

20. On the basis of the analysis performed above, with the outcome of the developing model, the staff do not believe there is any merit to having an objective as ‘approximating’ a yield adjustment as an objective. While having an objective trying to reflect an appropriate yield adjustment in the income statement is admirable, because the current model is focused on having an allowance balance at all times, a true yield objective will not be met. Even if an entity was able to calculate an integrated effective interest rate, they would still have an allowance balance that reflected the next [12 months, 24 months, emergence] period.
21. On the other hand, the objective of having an allowance balance that reflects the expected losses on the assets that have not yet materialised (ie experienced a meaningful deterioration in credit quality) is attainable. As a result, the staff recommend that the objective of the Bucket 1 allowance be described as such (ie Alternative 2).

**Question to the boards**

1. Do the boards agree with the staff recommendation that the objective of the Bucket 1 allowance should be to capture as the allowance balance, expected losses which have not yet materialised on assets in Bucket 1? If not, why not?

**Topic 2 – Measurement of Bucket 1 Allowance Balance**

22. Some believe that the appropriate measurement depends on the boards’ discussion on the principle to transfer loans to Bucket 2. This is certainly the case if the focus is ensuring the adequacy of the allowance balance. From the perspective of the adequacy of the allowance balance, a transfer into Bucket 2 that requires a significant deterioration in credit quality might imply that a larger allowance balance is required for Bucket 1. Other staff believe, while acknowledging that ‘too little, too late’ is a criticism of the incurred loss model, the adequacy of the allowance balance is the concern of prudential regulators rather than accounting standard setters.

23. A challenge for all of the alternatives below is to define what is meant by 'expected to materialise'. The expectations could be calibrated to charge-offs, defaults, delinquencies, or transfers into Bucket 2 (eg expected 'meaningful' deterioration).
24. As mentioned above, the staff have identified the following alternatives for the measurement of the Bucket 1 allowance balance:
- (a) Alternative A – shortfalls in cash flows expected to materialise in the next 12 months (eg using a 12 month probability of default (PD) notion)
  - (b) Alternative B – shortfalls in cash flows expected to materialise in the next 24 months (eg using a 24 month PD notion)
  - (c) Alternative C – shortfalls in cash flows expected to materialise over a emergence period as defined by one of the sub-alternatives below:
    - (i) Alternative C1 – No defining boundaries for the emergence period. Entities would consider all reasonable and supportable information available, including historical information in order to determine the appropriate emergence period for each asset class.
    - (ii) Alternative C2 – A minimum of 12 months is established, with no upper boundary.
    - (iii) Alternative C3 – Defining a range for an emergence period (eg between 12 and 24 months).

### **Alternatives A and B – 12 and 24 months**

25. These alternatives would limit the outlook period to 12 or 24 months (eg using a 12 or 24 month PD) for the amount of shortfalls in cash flows expected to occur (ie expected losses). Expected losses were discussed in IASB Agenda Paper 7B / FASB Memorandum 101 from the July 2011 joint board meeting. Expected losses refer to all shortfalls in cash flows (principal and interest). These alternatives would recognise shortfalls in **all** cash flows (ie lifetime) expected to materialise in the next 12 or 24 months (eg using a 12 or 24 month PD), not just



the shortfalls in the cash flows for the next 12 or 24 months (ie the cash not expected to be collected in the next 12 or 24 months).

*Advantages of both Alternatives A and B*

26. Both Alternatives A and B are operationally simpler than an approach based on a true yield adjustment.
27. Some believe this approach would provide useful information to users of financial statements regarding management's expectations about losses on financial assets that an entity expects to occur during the next 12 or 24 months.
28. Requiring the use of 12 or 24 months would be a consistent measure across all entities. As a result, this approach would not be as significantly reliant on disclosures for comparability between entities when compared to some of the other alternatives.

*Challenges of both Alternatives A and B*

29. There is no principle for why 12 or 24 months is used. It is simply an arbitrary amount creating a bright line.
30. Using a bright line amount of 12 or 24 months may result in a lifetime loss being recognised for some asset types. For example, in some retail portfolios or for other receivables, 12 or 24 months may be close to or more than the expected lifetime. Some limited feedback from outreach activities suggested that some entities would not be concerned by this outcome, and perhaps recognising a lifetime amount for such short term portfolios would be appropriate, anyway.
31. Because a loss is recognised immediately, this measure does not reflect the economics of a lending transaction, in either the income statement or balance sheet. Financial assets are initially recognised at fair value, and no additional impairment allowance should be necessary upon origination. On the basis of some feedback received, users are particularly opposed to recognition of losses on initial recognition of the financial asset.
32. This would not make a very good proxy for a yield adjustment. For example, in a static open portfolio or a closed portfolio with an even loss pattern, a yield adjustment may not occur (unless losses occur exactly as originally expected, and

at a constant rate over the life of the financial asset) because adjusting the allowance balance at the end of each period will not give a true yield adjustment effect on the income statement.

33. Changes in expectation of losses are only reflected to the extent the change is expected in the next 12 or 24 months. Even if the information is available, the approach would not fully consider losses that may be expected later in the life of the assets.

*Advantages of Alternative A: 12 months*

34. Considering current practice in many jurisdictions, we received a lot of feedback during outreach meetings and the Impairment Summit of August 2011 that this would not pose significant operational challenges in application for some constituents (see IASB Agenda Paper 4A / FASB Memorandum 109 of the September 2011 meeting). For example, many indicated that they currently use a measure for impairment based on a 12 month loss period. Therefore, since many already calculate a 12 month loss rate (ie what entities expect to lose in the next 12 months), this approach can be applied without significant systems and process changes. Furthermore, calculating the 12 months of losses aligns with the internal annual budgeting and forecasting processes of some institutions.
35. Using 12 months could also leverage the Basel capital framework for those banks applying the Internal Ratings Based approach which requires calculation of 12 months' expected losses. However, it should be noted that there are some important differences between the Basel II calculations based on 1 year EL for regulatory capital purposes and use of a 12-month EL measure for impairment accounting purposes. For example:
- (a) For Basel II parameters, an entity considers loss expectations through-the-cycle rather than assessing anticipated losses given the point in the cycle.
  - (b) The Basel II framework requires the use of downturn 'loss given default' (ie 'stressed' LGDs, or worst-case scenarios), whereas accounting EL would incorporate actual expectations of the future.

- (c) The Basel II parameters have floors that would need to be removed for accounting purposes.
  - (d) The Basel II definition of default (for the purposes of determining LGD) may differ from the accounting definition; therefore it is important to provide a clear definition of ‘default’. At the Impairment Summit it was emphasised that it is critically important that the same definition of default is used for accounting purposes.
36. Regardless of the outlook period used for Bucket 1, applying an expected loss approach (which moves assets to a Bucket 2 lifetime loss calculation sooner than the incurred loss notion of today) will likely result in a greater allowance balance (considering the required allowance for all 3 buckets) compared to allowance balances recognised today under the incurred loss model. Given that assets in Bucket 1 will be considered to be performing, some believe a complicated Bucket 1 measurement attribute is unduly onerous and the benefit (in terms of the incremental effect on allowance balances) versus the costs are limited. They believe that problem loans and the effects of significant credit deteriorations would be captured in Buckets 2 and 3 meaning that the expectations of loss for Bucket 1 should be comparatively low.

#### *Challenges of Alternative A: 12 months*

37. This approach may result in an overall lower impairment allowance than current practice in the U.S. This phenomenon is a result of two factors.
- (a) First, in practice the percentage of loans that are identified as ‘criticized or classified’<sup>2</sup> by U.S. banks is a relatively small percentage of total loans. For example, utilising data from the Share National Credits (SNC) analysis performed annually by U.S. regulators, the percentage

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<sup>2</sup> Includes all assets rated special mention, substandard, doubtful and loss. The ‘special mention’ category (which is the highest rating of those included in this group) is defined as having potential weaknesses that deserve management’s close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution’s credit position at some future date. Special mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.

of ‘criticized or classified’ loans ranged from 3.15% to 5.85% from 2004-2008.<sup>3</sup> While not perfectly indicative of the percentage of total loans that will qualify for Bucket 2 or Bucket 3 classification, this data suggests that a substantial majority of total credits would likely fall under the Bucket 1 measurement approach, as the ‘criticized or classified’ credits generally include those that have deteriorated subsequent to initial recognition to such a point that they are more closely monitored by management. This information is consistent with the amount of assets that some international banks suggested would be in Bucket 2<sup>4</sup>. However, we were not able to obtain the expected loss (ie allowance) numbers related to the SNC data in order to determine how much of the allowance balance is covered by loans in ‘criticized or classified’ as compared to higher quality loans. Appendix 1 to this paper includes a graph of the ‘criticized or classified’ credits as a percentage of total credits over time in the SNC review.

- (b) Second, in calculating the general loan loss reserve under current U.S. GAAP (which would generally equate to the allowance for non-criticised or classified loans), banks typically utilise a charge-off rate over a period of time greater than 12 months (often 18 or 24 months), particularly for commercial loans. That is, in determining the losses that have been ‘incurred’ and are inherent in the portfolio, U.S. banks today already use, for example, ‘losses expected to manifest in the next

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<sup>3</sup> Data compiled with the assistance of the Office of the Comptroller of the Currency from ‘Shared National Credits Program’ review reports. The most recent review report is dated August 2011, is publically available, and was issued by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency.

<sup>4</sup> Quantitative analysis was provided by some international banks which showed that for initially high quality assets, the expected losses (and therefore allowance balance) in Bucket 1 will not represent a significant amount of the entire allowance balance (when including Buckets 2 and 3). For example, the analysis showed the Bucket 1 allowance balance (using a 12 month number) would represent 5%-20% of the total allowance balance and 80%-95% of the total exposure. The analysis has been prepared based on a detailed analysis of actual loss statistics by several banks, and their estimates of expected losses, the sample provided is limited and thus is not statistically representative. While the data received is helpful in providing some indication about the importance of the measurement attribute for Bucket 1, it is not representative enough to draw general conclusions. The staff also do not believe that it will be possible, at least prior to full exposure, to obtain a fully comprehensive picture from constituents on this matter

18-24 months.’ This approach is consistent with the Interagency Policy statement that indicates, “Generally institutions should use least an “annualized” or 12-month average net charge-off rate that will be applied to the groups of loans when estimating credit losses. However, this rate could vary. For example, loans with effective lives longer than 12 months often have workout periods over an extended period of time, which may indicate that the estimated credit losses should be greater than that calculated based solely on the annualised<sup>5</sup> net charge-off rate for such loans. These groups may include certain commercial loans as well as groups of adversely classified loans.”<sup>6</sup>

#### *Advantages of Alternative B: 24 months*

38. Some staff believe this approach may be more responsive in addressing the ‘too little, too late’ criticism of current impairment models by extending the outlook period to a greater amount of expected losses. This is important for those who focus particularly on adequacy of allowance balance.
39. Particularly given the current practice in the U.S. (as described in paragraph 37 above), the use of 24 months would likely result in a total allowance balance that is at least equal to, if not greater than, existing practice, whereas 12 months may result in a total allowance balance that is less than existing practice (depending on when it is considered appropriate to recognise lifetime losses). This approach would allow those entities to continue to recognise 24 months’ worth of expected losses.

#### *Challenges of Alternative B: 24 months*

40. Many entities outside of the U.S. indicate that currently they have a 12-month outlook period, so requiring all entities to look out 24 months may create additional work, data collection, and modelling. As noted above, given the

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<sup>5</sup> By ‘annualized’, the staff understand that to be equivalent to how the boards have tentatively decided to define ‘annual’, that is, losses that are expected to occur in the next 12 months.

<sup>6</sup> Interagency Statement on the Allowance for Loans and Leases, p.10. Available at <http://www.federalreserve.gov/boarddocs/srletters/2006/SR0617a1.pdf>

quality of Bucket 1 assets and the size of allowance balances compared with today, they therefore question the appropriateness of this outlook period.

### ***Alternative C – Emergence period concept***

41. Under this alternative (and the various sub-alternatives), entities would recognise expected losses for assets in Bucket 1 based on the expected loss emergence patterns. For example, an entity would consider all reasonable and supportable information available to it, including historical information in order to determine the average period of time over which meaningful deterioration is expected to occur. That period would be used as the outlook period for the allowance balance calculation in Bucket 1.
42. The staff have identified sub-alternatives for this approach which relate to either establishing boundaries, for consistency in application, or leaving it open for entities to determine. The advantages and challenges to be discussed below are similar for each of the subalternatives. However, this paper will highlight if a particular advantage or challenge is not relevant to all of the following subalternatives:
  - (a) Alternative C1 – No defining boundaries for the emergence period. Entities would consider all reasonable and supportable information available to it, including specific historical information in order to determine the appropriate emergence period for each asset class.
  - (b) Alternative C2 – A floor of 12 months is established, but no upper boundary.
  - (c) Alternative C3 – Defining a range for an emergence period (eg between 12 and 24 months).

### ***Advantages***

43. This approach is potentially more responsive in resolving the ‘too little, too late’ criticism of current impairment models as it allows entities to extend the outlook period beyond 12 months or 24 months if appropriate as indicated by all

information available to it including historical experience, past loss emergence patterns, and forward looking information considered by the entity.

44. Some staff believe that an emergence period is more principles based in that entities are not limited to a 12 or 24 month loss horizon as a rule. Rather, an entity's management uses judgment to estimate the losses expected to occur on financial assets in Bucket 1 using an outlook period that reflects the period of time it takes for a relevant event to happen and when the effects are known. Some may view this as preferable to a single, strict bright line that cannot be expressed as having a conceptual underpinning.
45. Different asset classes have different expected lives and loss patterns, and as a result, have different loss emergence periods. In other words, entities will expect to lose cash flows in different time periods. Some question why a 12 month or 24 month period is appropriate for all asset classes in Bucket 1, particularly when some asset classes (eg commercial real estate mortgages, residential mortgages) have significantly longer expected lives and presumably longer emergence periods. Some believe allowing entities to use their expertise and judgment to determine the outlook period over which to estimate losses may result in a more meaningful allowance balance for Bucket 1.
46. This alternative may minimise implementation issues for entities, as the approach could be viewed as similar to the manner in which current U.S. GAAP and IFRSs are practically applied (ie under FAS 5, loss emergence periods are not specified and under IAS 39 the time period for IBNR is not specified).
47. Alternative C2 – placing a floor of 12 months ensures that entities are at least looking out 12 months, which we have consistently heard is a reasonable period over which to look (assuming the expected life is greater than 12 months).

### *Challenges*

48. Some argue that 'emergence' notions fit more naturally in an incurred loss model where it is difficult to identify when a loss has incurred on individual items on a timely basis (for example, to capture IBNR). Some are also concerned that like Buckets 2 and 3 if the emergence period covers the time over which meaningful deterioration is expected to occur on an asset, the allowance balance equates to all

expected losses on the loans that are expected to deteriorate in that period. Bucket 1 may end up also capturing lifetime expected losses. They are also concerned that it is a difficult concept to explain so may be subject to similar criticisms as the foreseeable future period in the joint supplementary document, *Financial Instruments: Impairment*.

49. Emergence periods may change over the life of assets, and depending on the economic cycle. As a result, this approach would be more operationally difficult than one that has a defined period because an entity would have to continually assess that it was using the appropriate emergence period using all information available to it.
50. Because different entities will use different emergence periods for different asset classes, there may be a lack of comparability in losses recognised for the Bucket 1 allowance. Some are concerned that jurisdictional differences may well develop. Staff notes, however, that because this project relies so heavily on management assumptions and estimates, comparability through any alternative for the measurement of the allowance balance will be achieved primarily through disclosure, not through measurement.
51. As a result, this approach will rely heavily on disclosures to achieve comparability, because the time horizons used will differ.
52. Alternative C2 and C3 – Putting any limits on the emergence period (whether lower and/or upper limits) adds arbitrariness to the measurement, and loses some of the conceptual thought behind an emergence period concept, in general.

### **Staff recommendation and question to the boards**

53. As noted in the paper, the staff struggled to find an objective for the Bucket 1 allowance. In paragraph 21, the staff recommended the objective should be to have an allowance balance that reflects expected losses which have not yet materialised (ie on which no meaningful deterioration has occurred) on the assets in Bucket 1.
54. The staff notes that all alternatives (A-C) attempt to recognise shortfalls in cash flows that are expected, but have not yet materialised. In that respect, all of the



approaches are more forward-looking than those used today. All the alternatives are attempting to anticipate deterioration in credit quality so that an adequate allowance balance can be recognised.

55. The question becomes over what period should the model try to capture the anticipated deterioration. The objective identified does not help answer this question. Some staff believe that using an emergence period notion allows too much additional flexibility in an impairment model, will lack comparability, and may be difficult to operationalise. As a result, these staff believe that, given the model will be more forward looking than it is under current accounting guidance, requiring the use of a particular time period is appropriate. Some of these staff believe a measure using 12 months is most appropriate due to the operationality in many jurisdictions and because it links to internal budgeting and forecasting processes.
56. Other staff believe that it would be inappropriate to prohibit entities from recognising a greater allowance if management deemed it appropriate, and would not provide a single bright line. Rather, they would prefer a principles approach with no boundaries (eg Alternative C1).

**Question to the boards**

Which alternative do the boards prefer for the Bucket 1 measure:

Alternative A – 12 months

Alternative B – 24 months

Alternative C1 – emergence period with no boundaries

Alternative C2 – emergence period with a minimum of 12 months

Alternative C3 – emergence period with a range (eg 12 to 24 months)? Why?

## Appendix

A1. The following chart, compiled with the assistance of the U.S. Office of the Comptroller of the Currency, shows the percentage of total credits that are considered 'criticized and classified,' based on the annual Shared National Credits Program review perform by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency.

