

# STAFF PAPER

**12 Dec – 16 Dec 2011**

## REG FASB | IASB Meeting

Project	Financial Instruments: Impairment		
Paper topic	Principle of transfer		
CONTACT(S)	<b>Jana Streckenbach</b>	<a href="mailto:jstreckenbach@ifrs.org">jstreckenbach@ifrs.org</a>	+44 (0)20 7246 6473
	Sara Glen	<a href="mailto:sglen@ifrs.org">sglen@ifrs.org</a>	+44 (0)20 7246 6933
	Yulia Feygina	<a href="mailto:yfeygina@ifrs.org">yfeygina@ifrs.org</a>	+44 (0)20 7332 2743
	<b>Steve Kane</b>	<a href="mailto:smkane@fasb.org">smkane@fasb.org</a>	+1 203 956 3424
	Rosemarie Sangiuolo	<a href="mailto:rsanguolo@fasb.org">rsanguolo@fasb.org</a>	+1 203 956 3426
	Trent Handy	<a href="mailto:tthandy@fasb.org">tthandy@fasb.org</a>	+1 203 956 3466

This paper has been prepared by the staff of the IFRS Foundation and the FASB for discussion at a public meeting of the FASB or IASB. It does not purport to represent the views of any individual members of either board. Comments on the application of US GAAP or IFRSs do not purport to set out acceptable or unacceptable application of U.S. GAAP or IFRSs. The FASB and the IASB report their decisions made at public meetings in FASB Action Alert or in IASB Update.

### Purpose of this paper

1. See the Cover Paper (IASB AP 6B / FASB Memo 119), for a brief background on the topic.
2. This paper further discusses the principle of when to transfer financial assets between Bucket 1 and Bucket 2. In other words, under which circumstances is it appropriate to recognise an impairment allowance equal to lifetime expected losses on a financial asset (or group of financial assets).
3. In particular this paper provides alternatives for the boards to consider regarding:
  - (a) When recognition of lifetime expected losses is appropriate.
  - (b) Whether the transfer to Bucket 2 shall be assessed based on the likelihood of not collecting all cash flows or expected loss.
  - (c) Indicators for when financial assets should be moved to Bucket 2.

**Issue 1 –When recognition of lifetime expected losses is appropriate**

4. At the October Board meeting, the boards asked the staff to develop a concept of deterioration in credit quality that would be an appropriate basis to cause a requirement to recognise lifetime losses (i.e., transfer of financial assets from bucket 1 to bucket 2). This issue addresses how to define, at a principle level, that concept of deterioration in credit quality. Potential alternatives for consideration are as follows:
5. **Alternative 1:** Timing for recognition of lifetime losses based on the extent of deterioration in credit quality since initial recognition.
- (a) **Alternative 1a:** Recognise lifetime losses when there has been *meaningful* credit deterioration since initial recognition. This alternative would not further define ‘meaningful’.
  - (b) **Alternative 1b:** Recognise lifetime losses when the entity no longer expects to receive *substantially all* of the cash flows expected at initial recognition due to deterioration in credit quality.
  - (c) **Alternative 1c:** Recognise lifetime losses when there has been *a more than insignificant* deterioration in credit quality since initial recognition.
  - (d) **Alternative 1d:** Recognise lifetime losses when the entity *no longer expects* the same credit risk as at initial recognition due to deterioration in credit quality.
6. **Alternative 2:** Timing for recognition of lifetime losses based on (1) the extent of deterioration in credit quality expected at initial recognition and (2) the resulting risk of not collecting the *contractual* cash flows.
- (a) **Alternative 2a:** Recognise lifetime losses when there has been a *more than insignificant* deterioration in credit quality since initial recognition AND it is *at least more likely than not* that the contractual cash flows may not be fully recoverable.
  - (b) **Alternative 2b:** Recognise lifetime losses when there has been a *more than insignificant* deterioration in credit quality since initial recognition

AND it is *at least reasonably possible*<sup>1</sup> that the contractual cash flows may not be fully recoverable.

- (c) **Alternative 2c:** Recognise lifetime losses when there has been *a more than insignificant* deterioration in credit quality since initial recognition AND it is *remote* that the contractual cash flows may not be fully recoverable<sup>2</sup>.

7. **Alternative 3:** Timing for recognition of lifetime losses based on deterioration in credit quality being such that it changes management's objective for managing the asset. For example when the holder's credit risk management objective changes from:

- (a) merely monitoring and analysing regular performance updates, to
- (b) actively engaging in managing the credit risk exposure to try to address the issues giving rise to the problems with the asset(s) and to allow appropriate re-calibration of the legal framework of the asset(s) taking into account the borrower(s) financial situation.

## **Discussion of alternatives**

### *Alternative 1 and Alternative 2 – Introduction*

8. Regardless of the alternative selected, the staff believe that one consideration in any model using deterioration as the underlying principle relates to the shape of the risk curves (ie the volatility in risk levels).
9. As described below, risk curves are typically not linear. Therefore, the staff believes that the appropriate amount of deterioration in credit quality (ie the meaningful deterioration) that warrants lifetime expected credit losses may vary depending on the credit risk at initial recognition.

---

<sup>1</sup> Reasonably possible is a term defined in FAS 5 as follows 'the chance of the future event or events occurring is more than remote but less than likely'.

<sup>2</sup> Some may interpret Alternative 2c as resulting in the same outcome as Alternative 1c.

10. Historical default data shows that default risk only increases moderately across the spectrum of credits within investment grade. However, once credit risk reaches higher levels, the shape of the risk curve changes, ie the gradient typically becomes steeper and the default rate increases at an accelerated level (this is sometimes described as a ‘hockey stick’). As a result of the non-linear risk curve, arguably deterioration in credit quality needs to be greater for assets that are of higher credit quality than those of lower credit quality to be meaningful.<sup>3</sup>

*Alternative 1 - Transfer based on extent of deterioration*

11. This alternative is based on deterioration in the credit quality of the financial asset since initial recognition. Alternative 1 inherently evaluates how the credit quality at initial recognition compares with the credit quality as of the evaluation date.

### *Advantages*

12. **Considers that credit risk is embedded in the pricing** – This alternative considers the concept that the expectation of credit losses is priced into the loan and that ‘meaningful’ deterioration in credit quality (however implemented) warrants a change to the immediate recognition of lifetime expected credit losses. Hence, conceptually, such a model based on deterioration in credit quality would not give rise to day 1 lifetime losses.

### *Disadvantages*

13. **Implementation issues** – Alternative 1 raises the question of how the extent of deterioration in credit quality should be assessed (eg assuming a focus on probability of default (PD), a change in percentage points (eg PD(0) plus x%) or a ratio of the initial credit risk (eg PD(0) doubled).

---

<sup>3</sup> In addition a rating transition matrix shows that the lower the credit rating, the higher the probability of a change in the rating one year later (compared to those unchanged), and that the probability of staying at a certain credit risk grade deteriorates disproportionately when moving down the credit quality spectrum. A rating transition matrix illustrates the relationship between the current ratings and the changes in those ratings N years later (for example, 1, 3, 5 years later) in terms of the probability based on past rating data.

14. Alternative 1 also raises the question of how significant the extent of deterioration in credit quality needs to be to warrant recognition of lifetime losses as discussed in paragraph 2.
15. **Operationally burdensome** - An approach based on deterioration in credit quality since initial recognition may require tracking the initial credit quality of loans to assess their overall credit risk migration. If tracking is required, as discussed in previous meetings constituents have told us that it is extremely burdensome from an operational perspective.<sup>4</sup> Also, this would need to be applied to all financial assets subject to impairment accounting so it would have to be implemented across a very large population.

#### Alternatives 1a-1d

16. The staff has considered the following alternative wording to capture the concept of Alternative 1 regarding when to recognise lifetime losses.
- (a) **Alternative 1a:** When there has been *meaningful* credit deterioration since initial recognition. This alternative would not further define ‘meaningful’.
  - (b) **Alternative 1b:** When the entity no longer expects to receive *substantially all* of the cash flows expected at initial recognition due to deterioration in credit quality.
  - (c) **Alternative 1c:** When there has been *a more than insignificant* deterioration in credit quality since initial recognition.
  - (d) **Alternative 1d:** When the entity *no longer expects* the same credit risk as at initial recognition due to deterioration in credit quality.
17. Alternative 1a would provide a principled approach (ie meaningful deterioration), but would not further define what constitutes ‘meaningful’. Alternatives 1b – 1d all strive to define the extent of deterioration (with an objective of trying to

---

<sup>4</sup> See paragraphs 14-33 of IASB Agenda Paper 4B / FASB Memorandum 110, week commencing 19 September 2011)

capture a measure that represents a meaningful deterioration in credit quality as requested by the boards).

### Alternative 1a

18. Some may prefer the more principles-based approach in Alternative 1a. Arguably it does allow people to consider the non-linearity of the risk curve and at the same time reduces the operational concern described in paragraph 15 above. This is because Alternative 1a would be broad enough that an entity may implement it in a manner consistent with Alternative 2. That is, the entity may determine that what is ‘meaningful’ to them is when there has been a more than insignificant deterioration in credit quality since initial recognition and there is some specified risk of not receiving the contractual cash flows. In that way, this alternative may actually be less burdensome, as it leaves open the opportunity for entities to interpret it and implement it in a manner that is meaningful to them, and to communicate via disclosure how they establish their boundaries for what constitutes a ‘meaningful’ deterioration in credit quality. Others are concerned that ‘meaningful’ is too broad without further definition or clarity at the principle level resulting in a lack of comparability of application and see Alternative 2 as another way of articulating ‘meaningful’ deterioration striving to define the ‘meaningful’ deterioration in credit quality.

### Alternatives 1b – 1d

19. Some may favour linking the extent of deterioration in credit quality that warrants recognition of lifetime losses to language that is more familiar to accountants, as Alternatives 1b-1d provide. Alternative 1d would be a very quick transfer point, as it could be interpreted to suggest that *any* deterioration would provide for transfer to Bucket 2. This is the only alternative where the disadvantage of the non-linear risk curve does not apply.
20. Conversely, the ‘substantially all’ or ‘more than insignificant’ language in Alternatives 1b and 1c would allow for greater deterioration in credit quality before causing a transfer to Bucket 2, while also keeping the extent of deterioration in credit quality to a relatively low level compared with, for

example, incurred loss triggers today. Some staff are however concerned that ‘substantially all’ or ‘more than insignificant’ does not in itself address the non-linear risk curve and that the extent of deterioration in credit quality would need to vary depending on the initial credit risk.

21. Some may also be concerned about the potential to apply mathematical approaches to determining whether the transfer point has been reached in Alternatives 1b and 1c. That is, using a percentage transfer point for what constitutes ‘substantially all’ or ‘more than insignificant’, the approach could lend itself to a mathematical exercise. This is not necessarily the staff’s intent, but we understand this could be the outcome given preparers and auditors often seek greater clarity than a high-level principle. If it were to be applied in a mathematical exercise, low credit quality assets would transfer to Bucket 2 relatively late (ie a greater extent of deterioration due to the initial high credit risk resulting for example in a B-rated loan deteriorating until CCC- before it is transferred to Bucket 2) under both Alternative 1b and 1c. This could mean that a high credit quality loan even though the credit risk is still de minimums could be moved to Bucket 2 under Alternative 1c.<sup>5</sup> If the transfer is based on an increase in the risk of not collecting all cash flows, some staff believe the risk of this becoming a mathematical exercise is reduced by the fact that PDs are not available or calculated for all asset classes, a prime example being retail loans.

*Alternative 2 – Extent of deterioration in credit quality AND resulting risk of not collecting the contractual cash flows*

22. Alternative 2 potentially alleviates some of the concerns with Alternative 1 by providing that only a low level of deterioration in credit quality needs to have taken place (a ‘more than insignificant’ change, consistent with Alternative 1c),

---

<sup>5</sup> Consider for example an unsecured loan where, on initial recognition, the borrower is virtually certain to pay the contractual cash flows (eg AA- or equivalent internal rating). At the next reporting period, the expected financial performance and therefore the repayment capacity of the borrower deteriorates, implying somewhat greater credit risk (eg moving from AA- to A-). At this point, the borrower would still have a strong capacity to meet its financial commitments but a ‘more than insignificant’ change may have taken place.

but that a transfer to Bucket 2 only occurs if the resulting risk of not collecting the contractual cash flows is meaningful. Meaningful can be described in different ways as shown in the variations of Alternative 2 below.

23. This alternative aims for good credit quality assets to transfer to Bucket 2 when the credit risk is at a level of significance. In addition, the alternative aims for assets of lower initial credit quality to experience a relatively low amount of deterioration in credit quality to be transferred to Bucket 2. Given the already high risk levels of not collecting at least part of the cash flows for a low credit quality asset at initial recognition and the steep increase in credit risk, much smaller deteriorations in credit quality are relevant compared to good credit quality assets<sup>6</sup>. This suggests that for low credit quality assets a transfer to Bucket 2 should occur if the asset deteriorates by an amount that is *more than insignificant*.

### *Advantages*

24. **Considers the point in the risk curve when uncertainty about recovery of cash flows becomes meaningful** – The transfer notion captures deterioration in credit quality since initial recognition but at the same time acknowledges that not every deterioration in credit quality since initial recognition implies a ‘meaningful’ increase in the uncertainty of fully recovering cash flows on the instrument (see paragraphs 22-23 above). It takes into account the non-linear shape of the risk curve by recognising that the credit quality following the deterioration is relevant.
25. **Considers that credit risk is embedded in the pricing** – This alternative considers the concept that the expectation of credit losses is priced into the loan and that ‘meaningful’ deterioration in credit quality (however implemented) warrants a change to the immediate recognition of lifetime expected credit losses.

---

<sup>6</sup> Moody’s data from the recent crisis also show that companies in the Ba to B ranges experienced downgrades to the Caa to C levels and that many companies at the lowest rating levels subsequently defaulted. (See Moody’s Investor Service: Special Comment, Non-Financial Corporates, Hanging Touch, October 2011, page 8-9).



Hence, conceptually, such a model based on deterioration would not give rise to day 1 lifetime losses.

26. **Less operational concerns** – Some believe this alternative may be more operational relative to Alternative 1. For example, for loan books originated at a high credit quality, all loans below the 'meaningful' risk level must have deteriorated to require transfer - so only a subset of loans needs to be tracked (ie the loans that are originated or purchased with low credit quality).

### *Disadvantages*

27. **A hybrid model** - As a drawback, this alternative is based on significant conceptual differences in capturing the deterioration of credit quality of assets as compared to Alternative 1. In effect this transfer notion combines the Alternative 1 above and the 'Credit Quality Approach'<sup>7</sup>. However, anything transferred must have suffered a more than insignificant decrease in credit quality.
28. **Implementation issues** – Alternative 2 may raise implementation questions about when the resulting risk of not collecting the contractual cash flows reaches the relevant level.

### Alternatives 2a-2c

29. The staff has considered the following alternative wording to capture the concept of Alternative 2.
- (a) **Alternative 2a:** Recognise lifetime losses when there has been a *more than insignificant* deterioration in credit quality since initial recognition AND it is at least *more likely than not* that the contractual cash flows may not be fully recoverable.
- (b) **Alternative 2b:** Recognise lifetime losses when there has been a *more than insignificant* deterioration in credit quality since initial recognition

---

<sup>7</sup> The Credit Quality Approach would have classified all assets into the buckets according to the level of credit quality. As a result, assets would not always be classified in Bucket 1 upon initial recognition.

AND it is at least *reasonably possible*<sup>8</sup> that the contractual cash flows may not be fully recoverable.

- (c) **Alternative 2c:** Recognise lifetime losses when there has been a *more than insignificant* deterioration in credit quality since initial recognition AND it is *remote* that the contractual cash flows may not be fully recoverable.

30. Alternatives 2a – 2c all strive to define the meaningful level of risk of not collecting the contractual cash flows (with an objective of trying to capture a measure that represents a meaningful deterioration in credit quality as suggested by some board members during the October 2011 joint board meeting).
31. Transferring a loan to Bucket 2 based on Alternative 2a would be very close to an incurred loss model. If an asset deteriorates to those levels, borrowers are already stressed to distressed, and time to default is typically short (eg about 2 years or less) and expected non-collectability of cash flows is high. Also a probable notion<sup>9</sup> is inherent in IAS 39 today so this raises the question of how much more forward looking the approach would be. In contrast, others believe that truly meaningful increases in credit risk only occur at these levels so earlier transfer would be inappropriate. Also some data we have received indicates that a significant portion of the total allowance would be included in Bucket 2 if transfer occurred at this level.<sup>10</sup>
32. Alternative 2c would result in very early recognition of lifetime losses. The obligor's capacity to meet its financial commitment would still be considered strong, reflected in a very low uncertainty about the inability to collect all cash flows.
33. Alternative 2b aims to capture the point where the shape of the risk curve changes, ie where the gradient for the risk of not collecting all contractual cash

---

<sup>8</sup> Reasonably possible is a term defined in FAS 5 as follows 'the chance of the future event or events occurring is more than remote but less than likely'.

<sup>9</sup> Probable is equivalent to 'more likely than not' in IFRS.

<sup>10</sup> It is noted that the data provided has been prepared based on a detailed analysis of actual expected loss statistics by several banks, however the sample provided is limited and thus is not statistically representative.

flows typically becomes steeper and the default rate increases at a more accelerated level than previously. An asset at those levels is viewed as becoming more vulnerable to adverse economic conditions and changing business or financial circumstances which *could* lead to the inability to fully recover cash flows in the medium to short term. These levels of credit risk become meaningful in the sense that credit risk has reached a point at which the risk of an actual default becomes high enough to make investors think that the possibility of default actually occurring is reasonably possible.<sup>11</sup>

34. A transfer to Bucket 2 based on this notion in alternative 2b would address concerns about ‘too little, too late’ with the incurred loss model because it provides for earlier loss recognition. On the other hand, the operational complexities heighten. The higher the credit quality, the more financial assets would need to be tracked.

*Alternative 3 – Deterioration in credit quality resulting in a change in management’s objective*

35. Alternative 3 provides a different approach, where the transfer to Bucket 2 is based on whether the credit deterioration changes the entity’s management objective for the asset (eg from merely monitoring and analysing regular performance updates, to actively engaging in managing the credit risk exposure). This section illustrates the challenges discussed in the October board paper.<sup>12</sup>
36. One of the challenges is identifying an appropriate principle related to credit risk management (and, the resulting uncertainty in collectability of cash flows) that is

---

<sup>11</sup> To put those descriptive definitions into perspective, as represented by probability of default in numerical terms, the distinction between loans before and after this point becomes clearer. A typical loan with a five-year maturity in the highest non-investment grade category BB has an average probability of default of 11.5% over the life of the loan. This number increases to 26.5% for B-rated loans and becomes very high, at 51.8% for loans rated CCC. In comparison, a five-year loan rated at the lowest investment grade category of BBB shows only an average probability of default of 2%. There is a clear step-up in risk by a factor of more than 5x going from a 2% PD for BBB investment grade to an 11.5% PD for the next category down (BB) in non-investment grade territory. See Moody’s Investor Service (2011): Special Comment: Corporate Default and Recovery Rates, 1920-2010, Exhibit 35, p. 33. Note that the default rates in Exhibit 35 are referenced to the specific time from 1983-2010 and could differ if referenced to a different time period.

<sup>12</sup> See board meeting week commencing 19 October 2011, IASB Agenda Paper 3A, FASB Memorandum 113, par. 34-39.

sufficiently clear to result in a comparable grouping of credit qualities of assets in each of bucket. The joint Supplementary Document (the SD), *Financial Instruments: Impairment*, included a credit risk management principle to describe the split between the good and bad books. However, constituents were concerned that the description of the split between the good and bad book in the SD was unclear. Although they believed they could operationalise it by, for example, looking at a regulatory definition of a ‘bad loan’<sup>13</sup>, respondents asked that the principle be clarified.

37. In addition, based on discussions to date, the staff believe that the boards intend that the Bucket 1/Bucket 2 split be at a higher level than the good/bad book split in the SD. This will probably make it even *more difficult* to define a clear principle because the change in management would be even more subtle. This would make it both hard to define and harder to operationalise than the principle in the SD.
38. As a result, the staff have not further developed this approach.

#### Question to the boards

1.1 – Which (if any) of the alternatives described in paragraphs 5-7 do the boards prefer?

## Issue 2: Whether the transfer should be based on probability of default (PD) or expected loss (EL)

39. Given the boards tentatively decided to pursue a model in which the overall objective is to reflect the deterioration in the credit quality of financial assets, it follows to base the transfer notion between the buckets on deterioration or improvement in credit quality. The question that follows from that decision is whether ‘credit quality’ is either (a) the likelihood of not receiving the cash flows

---

<sup>13</sup> ‘Bad loans’ relate to a lower level of deterioration in credit quality than the staff currently envisages for the split between Buckets 1 and 2. As a result, trying to operationalise the split between Buckets 1 and 2 by using regulatory definitions for a ‘bad loan’ would not result in loans transferring to Bucket 2 in a timely manner.

expected on the financial asset (that is, the probability of default<sup>14</sup>) or (b) the expected loss which is calculated using the PD, the extent of 'loss given default' (LGD) and 'exposure at default' (EAD).

### ***Transfer based on likelihood of not collecting all cash flows***

40. As loans deteriorate in credit quality, the probability of default increases. The boards have previously indicated<sup>15</sup> that a transfer of loans from Bucket 1 to Bucket 2 should occur when a deterioration in the ability to fully recover cash flows (ie interest and principal payments) occurred using the PD as the criterion. Generally, the analysis of whether or not a transfer to Bucket 2 should occur shall also incorporate an assessment about changes in loss given default. That is because changes in LGD can indicate a change in PD.
41. For example, consider loans secured by a ship as collateral. During economic downturns, shipping companies face revenue and cash flow pressure, which increases the risk of default. Simultaneously, the ship collateral values drop with the decrease in market charter rates. Alternatively, consider a mortgage loan. If property values decline and the buyer will only be able to refinance a lower amount of debt than initially borrowed at an upcoming maturity during the downturn, his default risk increases if he does not provide, or becomes financially stressed when providing, the additional necessary equity.

### ***Disadvantages***

42. A transfer notion based on only PD would not capture situations where LGD increases but PD does not increase. Consider a loan where LGD increases but PD does not increase. The loan would not transfer to Bucket 2 even though it might have the same expected loss as a loan that is transferred to Bucket 2 (ie where PD

---

<sup>14</sup> Although PDs are not used in many cases for retail loans, other factors such as expected delinquency rates, FICO scores and other factors are indicators to assess the expected uncertainty to not recover all cash flows (see IASB Agenda Paper 4C / FASB Memorandum 111 of the 19 September 2011 joint board meeting).

<sup>15</sup> September 2011 joint board meeting

increased but LGD did not increase). Economically both instruments could have the same expected loss but are treated differently.

43. However, it is important to note that in situations where LGD changes after initial recognition of the loan but the PD does not change in conjunction with the increase in LGD, the allowance balance in Bucket 1 would still reflect the increase in the expected loss (through an update of the expected loss calculations).
44. Some have raised concerns that there may be an increase in the PD but no increase in LGD (for example due to access to collateral). Those raising this issue question the appropriateness of a transfer to Bucket 2 in this situation as in the extreme there may be little or no expected loss due to collateral. It is noted however that the transfer in this case would not result in inappropriate allowance balances being established because the whole expected loss would be recognised, so if it is de minimis then the impact of the transfer would be de minimis.

#### *Advantages*

45. PD is the main indicator for credit risk accepted in a market context. In many cases it is an accepted market standard to look at PD as the main driver for assessing whether a loss might occur.
46. In addition, investors typically are more likely to come to a common conclusion on the risk of default for a borrower/loan irrespective of which instrument in the capital structure they might hold compared to other measures such as LGD or expected loss.
47. In August, when members of the IASB and FASB held a meeting with credit risk managers from banks from different jurisdictions, the majority of the participants supported bucketing according to the ability to fully recover cash flows (ie PD), stating that in most cases this measure is used by entities in their internal risk management assessment.
48. Although PDs are not used in many cases for retail loans, other factors such as expected delinquency rates, FICO scores and other factors are indicators to assess the expected inability to fully recover cash flows (see IASB Agenda Paper 4C / FASB Memorandum 111 of the 19 September 2011 joint board meeting).

49. We have been told that tracking of PD is more simple than tracking expected loss which would require tracking of LGD and possibly EAD.

*Staff recommendation*

50. Staff believe that the deterioration model the boards have been discussing uses as a premise the ‘likelihood of not receiving the cash flows expected on the financial asset’ (ie PD). That is, while LGD is important to the model (because it affects the measured amount of impairment allowance), it does not affect the determination of whether a financial asset has experienced a credit deterioration that would warrant transfer to Bucket 2.

**Question to the boards**

2.1 - Do the boards agree with the staff that the recognition of lifetime credit losses should be based on credit deterioration (that is, the likelihood of not collecting all cash flows) as opposed to the likelihood of experiencing a loss (that is, the likelihood of default and the ‘loss given default’)?

**Issue 3 – Indicators for when the recognition of lifetime expected losses is appropriate**

51. The analysis to determine whether recognition of lifetime expected losses is appropriate (ie that a transfer should be made to Bucket 2) under the three-bucket model would be based on all available reasonable and supportable information such as historical data, current economic conditions, and expected economic conditions (including expectations based on supportable forecasts of future events and economic conditions) as previously tentatively agreed by the boards. Significant management judgement will be required to determine if a deterioration is sufficient to warrant transfer to Bucket 2 (causing recognition of lifetime expected losses).
52. In addition to developing a principle for when recognition of lifetime expected losses should occur (that is, when transfer to Bucket 2 is appropriate, as discussed in Issue 1), the staff have identified potential indicators of when an asset may have experienced a deterioration in credit quality for the boards to consider.

These indicators are intended to facilitate the application of the principle consistent with the notions set forth in Issue 1.

53. The staff believe that different indicators will be appropriate for different types of financial assets.

### ***Potential Indicators***

54. **Change in general economic conditions:** Existing or forecasted adverse changes in the national or local economic conditions that are expected to negatively affect the future ability of the borrower to meet its obligations.
55. **Change in industry conditions:** Changes in conditions or trends affecting the industry of the borrower that are expected to negatively affect the future ability of the borrower to meet its obligations.
56. **Change in market indicators of credit risk:**
- (a) If there is a significant widening of the credit spread for a particular financial asset or similar financial assets.
  - (b) If there is an actual or expected credit rating downgrade for the borrower.
  - (c) For securities, the length of time and the extent to which the fair value of the debt security has been less than the amortised cost.
57. **Change in re-origination rates:** If an existing financial asset was newly originated or issued at the reporting date, it could be originated or issued with terms that would be significantly different than the previous asset (such as more stringent covenants, a significant increase in interest rate, increased amounts of collateral or guarantees, or higher income coverage) because of the higher credit risk of the asset compared to its credit risk at inception.
58. **Change in management approach:** If, based on emerging indicators of changes in credit quality of the financial asset, the entity's credit risk management practice becomes more active or focused in managing the loan. This would include a loan becoming closely monitored or controlled, or the entity specifically intervening with the borrower.



59. **Change in company performance:** Changes in factors specific to the borrower; for example, changes in operating results of the entity (i.e. trends and projections in operating results, such as declining revenues or margins), operating risks, asset quality, balance sheet leverage, liquidity or management problems, that are expected to negatively affect the future ability of the borrower to meet its obligations.
60. **Change in company prospects:** Changes in the borrower's prospects for future business potentially negatively affecting the borrower's capacity to repay. This would include an actual or expected significant adverse change in the regulatory, economic, or technological environment of the debtor or the discontinuance of a segment of the business that is expected to negatively affect the future earnings potential of the issuer or underlying loan obligors of the security.
61. **Change in collateral values:** Changes in the value of the collateral supporting the obligation, which are expected to reduce the borrower's economic incentive to make scheduled contractual payments.
62. **Change in credit quality enhancements/support:** Reductions in financial support from a parent entity or other affiliate, an actual or expected significant change in the quality of credit enhancement, if any, including consideration of the financial condition of the guarantor and/or, for interests issued in securitisations, whether subordinated interests are expected to be capable of absorbing estimated losses (eg on the loans underlying the security).
63. **Change in the loan documentation:** An expected breach of contract, such as an expected breach of loan covenants, which may lead to covenant amendments, interest payment holidays, interest rate step ups, requiring additional collateral or guarantees, or other re-calibrations of the legal framework of the asset taking into account the borrower's financial performance.
64. **Change in expected performance of the borrower ('lagging' indicators if not based on expectations):**
- (a) Changes in the expected payment status of borrowers in the group (eg a significant increase in the expected number or extent of delayed contractual payments or a significant increase in the expected number

of credit card borrowers who are expected to reach their credit limit or expected to be paying the minimum monthly amount).

- (b) Expectation that the lender, for economic or legal reasons relating to the borrower’s financial difficulty, might grant to the borrower a concession that the lender would not otherwise consider.

A significant increase in the likelihood of the borrower entering bankruptcy or other financial reorganisation proceedings.

- (c) An actual or expected significant change in the factors about the debtor’s ability to continue as a going concern, such as negative cash flows from operations, working capital deficiencies, or noncompliance with statutory capital requirements or debt covenants.

65. **Other:** Other factors specific to the entity that may negatively affect the capacity to repay (eg pending litigation).

66. If the boards were to decide on Alternative 2 in Issue 1 of the Boards paper “Principle of transfer” (IASB Agenda ref 6B/ FASB ref 119), the indicators for when to recognise lifetime losses would be updated accordingly. Such as for example it becoming *reasonably possible/more likely than not (or other notion)* that the borrower will enter bankruptcy or other financial reorganisation proceedings. Or for example, current and projected changes in economic and business conditions indicating that the borrower faces major ongoing uncertainties and is vulnerable to adverse economic conditions and changing business or financial circumstances which *could/are more likely than not* to lead to the inability to fully recover cash flows in the medium to short term.

#### Question to the boards

3.1 Do the boards agree with the indicators proposed by the staff in paragraphs 54 through 65?

3.2 Are there any incremental indicators that the boards think are appropriate and should be considered?