

STAFF PAPER

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Project	Financial Instruments: Impairment		
Paper topic	Pervasive issues		
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Purpose of this Paper

1. This paper discusses two pervasive issues that affect the three-bucket model the boards are currently discussing:
 - (a) The requirements surrounding aggregation of individual financial assets into groups of financial assets to be evaluated collectively for credit impairment
 - (b) What (if anything) distinguishes Bucket 3 from Bucket 2 and, as a result, the “unit of evaluation” for each bucket in the model.
2. These issues are instrumental to developing the three-bucket model, as these issues provide the context for other key issues being considered by the boards. For example, in developing a principle for when recognition of lifetime losses is appropriate (see IASB AP 6B and FASB Memo 119), it is important to understand the restrictions surrounding the grouping of financial assets, because the level of aggregation can influence an entity’s determination of whether the recognition of lifetime losses is appropriate for that group of financial assets.

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3. Similarly, in considering how the three-bucket model would be applied, it is important to understand the following:
- (a) Whether there is a different “deterioration principle” for Bucket 3 (and if so, what that principle may be), or
 - (b) Whether there is a different “unit of evaluation” for the three buckets (for example, whether Buckets 1-3 can all include financial assets evaluated collectively for impairment).

Background and previous tentative decisions

4. Within the context of the three-bucket model under consideration, the boards have not previously discussed the aggregation of financial assets for purposes of evaluating an impairment allowance. To be clear, by “evaluating” we are referring to the process of determining whether certain portions of the portfolio qualify for transfer to Bucket 2 or Bucket 3.
5. The boards also have not reached any conclusions related to factors (if any) that differentiated Bucket 3 from Bucket 2. However, in Agenda Papers presented at the June 2011 meeting, a differentiating factor between Bucket 3 and Bucket 2 was whether expected losses on loans could be specifically identified, with Bucket 3 representing when expected losses on individual loans are specifically identified and Bucket 2 representing when expected losses on loans are not individually identified.¹ It is however noted that in June 2011 the basis for transferring loans between buckets was different to that now being considered (at that time it was based on the nature of the triggers which were yet to be determined) and this may have influenced the discussion at that time.

¹ Refer to paragraphs 9-10 in IASB Agenda Paper 8 / FASB Memo 99 for the June 2011 joint meeting.

Issue 1: Grouping of financial assets for impairment evaluation

6. In developing the three-bucket model, the staff considered the type of guidance that should be included regarding when and how an entity should be expected to aggregate individual financial assets into a group of financial assets for purposes of evaluating credit impairment.
7. This issue is important because the model under development does *not* use the same outlook period to recognize expected losses for all financial assets (that is, some financial assets will have a lifetime expected loss allowance and some financial assets will have something less than a lifetime expected loss allowance). As a result, it is important to provide guidance on the level of granularity with which entities need to evaluate groups of assets within their portfolio (when group analysis is relevant). If no such guidance were provided, different results could be achieved by changing the way in which a portfolio is selected. For example, an entity could evaluate their portfolio at a high level of aggregation that indicates the entire portfolio should not be transferred to Bucket 2 despite the fact that certain sub-components of the portfolio would qualify for transfer to Bucket 2 if evaluated at a lower level of granularity.
8. In presenting this issue, this section of the paper includes the following:
 - (a) a summary of existing and proposed guidance
 - (b) the staff recommendation
 - (c) a question to the boards regarding the staff recommendation.

Existing (and previously proposed) guidance

9. Current U.S. GAAP includes specific guidance regarding grouping of financial assets within the context of pools of loans acquired with evidence of deterioration of credit quality since origination. Specifically, paragraph 310-30-15-6 (formerly SOP 03-3) allows entities to aggregate such loans when they have common risk characteristics. “Common risk characteristics” is defined as similar credit risk (for example, evidence by similar FICO scores) or risk ratings, and one or more

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predominant risk characteristics, such as financial asset type, collateral type, size, interest rate, date of origination, term, and geographic location.

10. Current IFRS includes specific guidance regarding groupings of financial assets in IAS 39.64 that an entity collectively assess groups of financial assets for impairment if the individual assets were either (a) not evaluated individually or (b) evaluated individually but not considered impaired (i.e., for the purpose of determining IBNR). For the purpose of a collective evaluation of impairment under IAS 39.AG87, financial assets are grouped on the basis of similar risk characteristics that are indicative of the debtor’s ability to pay all amounts due according to the contractual terms (for example, on the basis of a credit risk evaluation or grading process that considers asset type, industry, geographical location, collateral type, past-due status and other relevant factors).
11. In addition to existing U.S. GAAP and IFRS, the boards’ January 2011 proposed joint Supplementary Document *Financial Instruments: Impairment* (the SD), which was designed primarily to address impairment accounting for open portfolios, provided that credit losses be estimated for each portfolio (or group of portfolios). The SD defined “portfolio” as a grouping of financial assets with similar characteristics that are managed by a reporting entity on a collective basis. Paragraph B1 of the application guidance in the SD provided that the characteristics used in defining a portfolio include asset type, industry, credit risk ratings, geographical location, collateral type, and other relevant factors.

Staff analysis

12. In summarizing the guidance, the staff note that existing guidance and the proposal in the SD emphasize “shared risk characteristics” as the principle defining how individual financial assets should be aggregated into groups. The staff also note that the guidance in IAS 39 is explicit that individual financial assets that are not deemed individually impaired should be considered for collective impairment by aggregating such assets into relevant groups. The guidance in IAS 39 differs slightly from the recommendation in this paper because the group assessment in IAS 39 is to determine the measure of losses recognized,

and in particular is used to identify losses that may have been incurred within a portfolio when those losses cannot yet be individually attributed to an asset, whereas the recommendation in this paper is to determine when recognition of lifetime losses is appropriate. However, the staff believe that existing guidance may be leveraged in developing the three-bucket model.

13. The staff suggests the concepts in paragraphs 14-17 be included in the guidance for the impairment model related to the grouping of financial assets. The guidance for grouping would be applied for the purposes of determining whether it is appropriate to recognize expected lifetime losses for the financial asset(s).

Objective of grouping

14. The objective of grouping is to segregate the financial assets into sub-populations of sufficient granularity to evaluate the groups for impairment (that is, to identify whether the recognition of lifetime losses is appropriate for that sub-population as of the assessment date).
15. An entity may not group financial assets at a more aggregated level if there are *shared risk characteristics* for a sub-group that would indicate whether recognition of lifetime losses is appropriate.
 - (a) Shared risk characteristics may include the following: asset type, credit risk ratings, past-due status, collateral type, date of origination, term to maturity, industry, geographical location of the debtor, the value of collateral relative to commitment for non-recourse assets (which may influence likelihood of debtor electing to default), and other relevant factors. Groups shall be created based on shared risk characteristics as of the assessment date (that is, the groupings may change each period).
16. If a financial asset cannot be included in a group because the entity does not have a group of assets that share the risk characteristics of that asset, or if a financial asset is individually significant, an entity is *required* to individually evaluate whether the recognition of expected lifetime losses is appropriate for the financial asset.

17. If a financial asset shares risk characteristics with other assets held by the entity, an entity is *permitted* to individually evaluate a financial asset within that group or include it in a collective evaluation of a group of financial assets with shared risk characteristics to determine whether the recognition of expected lifetime loss is required.
18. The staff think these concepts are consistent with the direction of both existing guidance and the SD.

Question to the boards

- 1.1 Regarding aggregation into groups of financial assets for purposes of evaluating whether a lifetime loss should be recognized, do the boards agree with the concepts described in paragraphs 14-17?
- 1.2 Are there any additional elements that the boards believe should be added to those concepts?

Issue 2: The differentiating factor between Bucket 2 and Bucket 3

19. In developing the three-bucket model, the staff considered what distinguishes Bucket 2 from Bucket 3. In analyzing this topic, the staff utilized particular assumptions to limit the approaches considered. The staff think that these assumptions are consistent with the boards' previous tentative decisions, however the staff recognize that these assumptions are subject to change. The assumptions utilized are as follows:
- (a) the model includes three buckets
 - (b) financial assets start in Bucket 1 upon initial recognition
 - (c) the model is based on deterioration in credit quality
 - (d) the objective of the credit allowance measure for Bucket 2 and Bucket 3 is the same (that is, expected lifetime losses)

- (e) no financial assets utilize a “non-accrual status” accounting approach, (such that Bucket 3 is not differentiated from Bucket 2 by a different interest income recognition model)²
- (f) particular individual assets (or parts of individual assets) are removed from the balance sheet via a direct reduction in the asset’s carrying amount (that is, by reducing both the allowance and the loan balance) prior to legal extinguishment of the financial asset³.

How the existing accounting models consider “unit of evaluation” for impairment

20. Under U.S. GAAP (Section 310-10-35, formerly FAS 114), particular loans are individually evaluated for impairment. Loans that are (a) not considered impaired on an individual loan basis or (b) not evaluated on an individual loan basis are assessed collectively for impairment (under Subtopic 450-20, formerly FAS 5). Debt securities are evaluated on the individual security basis (under Section 320-10-35, formerly FSP FAS 115-1 as amended by FSP FAS 115-2). Additionally, under U.S. GAAP, loans and debt instruments acquired with evidence of deterioration of credit quality since origination are evaluated for impairment at the individual or pool level (under Subtopic 310-30, formerly SOP 03-3).
21. Current IFRS (IAS 39.64) requires that an entity first assess credit impairment at the individual financial asset unit of account level, when such an asset is “individually significant.” Entities also may elect to evaluate other assets individually for credit impairment. However, if an individually evaluated financial asset is not impaired, IFRS requires that the individual asset be assessed for impairment on a collective basis based on its relevant group (as described in Issue 1). If an entity does not have a group of assets with similar risk characteristics, the entity would not evaluate the financial asset on a collective

² This is based on the boards’ tentative decision at the April 13, 2011 joint meeting that they did not need to consider the inclusion of a nonaccrual principle for an impairment accounting model because the measure of impairment is based on all shortfalls in cash flows (both principal and interest) on a discounted basis.

³ This is based on the boards’ decision at the February 17, 2011 joint meeting that an entity shall write off a financial asset or part of a financial asset in the period in which the entity has no reasonable expectation of recovery of the financial asset (or part of the financial asset).

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basis with other assets and, therefore, a collective credit impairment allowance would not be recognized for that asset (IAS 39.AG87).

Current issue

22. This issue seeks the boards' view on the key factor that differentiates Bucket 2 from Bucket 3. More specifically, the issue is whether Bucket 3 is:

- (a) differentiated from Bucket 2 by a different "credit deterioration principle" (that is, the credit quality of assets in Bucket 3 have deteriorated more than assets in Bucket 2),
- (b) differentiated from Bucket 2 by a different "unit of evaluation," in which Bucket 3 includes financial assets evaluated *individually* meeting the criteria for recognition of lifetime losses and Bucket 2 includes financial assets evaluated *collectively* meeting the criteria for recognition of lifetime losses, or
- (c) not differentiated from Bucket 2 and, therefore, Buckets 2 and 3 should be merged.

Staff analysis

23. Based on the boards' tentative decisions to date, the recognition and measurement approach for financial assets categorized in Bucket 2 is the same as those assets categorized in Bucket 3.⁴

- (a) In February 2011, the boards reached a tentative decision that an entity should write-off a financial asset, or part of a financial asset (that is, record a direct reduction of the amortized cost of a financial asset) when the entity has no reasonable expectation of recovery.
- (b) In April 2011, the boards reached a tentative decision that they did not need to consider the inclusion of a nonaccrual principle for an impairment accounting model because the measure of impairment is

⁴ With the exception of purchased "bad" loans, which is a question still to be brought to the boards for consideration.

based on all shortfalls in cash flows (both principal and interest) on a discounted basis.

- (c) In June 2011, the boards reached a tentative decision that the allowance measurement of Buckets 2 and 3 should be the remaining lifetime expected loss estimate.
24. Unless the boards revise a previous tentative decision, the staff believe that the distinction between Bucket 2 and Bucket 3 is relevant solely for information purposes. Three alternatives are discussed regarding the possible differentiating factor between Bucket 2 and Bucket 3:
- (a) **Alternative 1** – There is a different “deterioration principle” between Bucket 2 and Bucket 3, such that Bucket 3 represents a level of deterioration that is (a) more severe than the level of deterioration for Bucket 2, but (b) not severe enough that the entity determines it has no reasonable expectation of recovery for the asset (or part of the asset), which would warrant a direct write-off of the carrying amount. This Alternative has two sub-alternatives reflecting how the transfer point is established:
- (i) **Alternative 1a** – The transfer point for entry into Bucket 3 would be based on the *degree* of credit deterioration since initial recognition. For example, a financial asset (or group of financial assets) would be required to be transferred to Bucket 3 when there has been more severe credit deterioration in comparison to the credit deterioration that resulted in transfer from Bucket 1 to Bucket 2.
- (ii) **Alternative 1b** – The transfer point from Bucket 2 to Bucket 3 would be based on deterioration to a particular *level* of credit risk.
- (b) **Alternative 2** – There is a simply a “unit of evaluation” difference between Bucket 2 and Bucket 3, in which Bucket 2 only includes financial assets evaluated *collectively* and Bucket 3 only includes

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financial assets evaluated *individually* (both buckets including financial assets that qualify for recognition of expected lifetime losses).

- (c) **Alternative 3** – There is neither a “deterioration principle” difference nor a “unit of evaluation” difference between Bucket 2 and Bucket 3. Therefore, the two buckets act as a single bucket and should be merged.

Alternatives 1, 1a and 1b – Deterioration principle difference

25. Under Alternative 1, each bucket would include both assets evaluated individually and assets evaluated collectively for impairment.⁵ An additional principle related to credit quality deterioration would be required for transfer to Bucket 3. That incremental principle would need to be based on something less than the point of write-off.⁶ In the U.S., the staff understand that the point of write-off for most retail loans is a 120 days past due delinquency status. In other jurisdictions, however, the staff understand that write-off can occur anywhere from 90-180 days past due, depending on the asset type and the jurisdiction.
26. If the boards favor this alternative, the approach for developing the incremental principle for Bucket 3 will need to be further considered and developed by the staff. Alternatives 1a and 1b provide conceptually different approaches that could be followed in developing the incremental transfer point and are similar to the issues discussed in IASB AP 6B / FASB Memo 119 regarding the transfer principle from Bucket 1 to Bucket 2.
27. Alternative 1a provides that the to-be-defined transfer point would be based on a deterioration notion (similar to that being developed for transfer to Bucket 2). Under this alternative, a financial asset (or group of financial assets) would be required to be transferred to Bucket 3 when there has been a more severe credit deterioration in comparison to the credit deterioration that resulted in the transfer

⁵ Under this alternative, some believe that it is unlikely that Bucket 3 would include a group of financial assets because loans in Bucket 3 would have deteriorated to an extent that the entity would monitor and evaluate the loan on an individual basis.

⁶ That is, “no reasonable expectation of recovery,” based on the tentative decisions reached in February 2011.

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from Bucket 1 to Bucket 2 (for example, an “extremely meaningful” level of deterioration since initial recognition).

28. Alternative 1b provides a different approach for developing the incremental transfer point. Under this alternative, the to-be-defined transfer point would be based on deterioration to a particular *level* of credit risk as of the balance sheet date. Under this alternative, the staff would better define the level of credit risk at which a financial asset (or group of financial assets) would be transferred to Bucket 3 (for example, that transfer point could be when an asset has deteriorated such that the probability of default is greater than 30% or consumer loans are past-due by 90 days).
29. Some think Alternative 1 may provide users with valuable information that can be communicated through development of a second “deterioration principle.” For example, an asset in Bucket 3 is less likely to improve and move out of that bucket than one that is in Bucket 2 - so differentiating between the buckets provides additional information. This Alternative can be consistent with the three bucket deterioration model, and retain the deterioration notion in developing the second principle.
30. Others may question the comparability that would be achieved by including a second deterioration principle particularly if Alternative 1a is preferred. For example, the judgment that would be required in practice to implement the principle for transfer to Bucket 2 may be compounded by requiring an additional principle based on deterioration and result in a greater degree of incomparability across entities.
31. Conversely, Alternative 1b may alleviate some of the concerns associated with Alternative 1a about comparability because it would utilize deterioration to a particular level of credit risk for determining when financial assets would be transferred from Bucket 2 to Bucket 3. However some may be concerned that Alternative 1b is not aligned with the objective of a model focused on deterioration in credit quality subsequent to initial recognition. Others believe Alternative 1b is aligned with the objective of a model focused on deterioration in

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credit quality subsequent to initial recognition because Alternative 1b is based on *deterioration* to a specific level of credit risk.

32. Finally, others do not favor development of an incremental principle for Bucket 3. They are concerned that the cost of tracking financial assets using an additional principle will outweigh the benefit of doing so. These individuals also think that the timeframe during which a financial asset remains in Bucket 3 will be relatively short, because of the existing tentative decision to write-off financial assets when there is no reasonable expectation of recovery (which in the U.S. is typically 120 days past due for retail loans or between 90-180 days past due in other jurisdictions).
33. If the boards favor Alternative 1, the boards could choose to allow a further simplification of the model for those entities whose credit risk management approach is more simplistic by allowing such entities to combine Bucket 2 and Bucket 3. This simplification would allow greater granularity and information for those entities that have more sophisticated risk management and choose to follow a three-bucket approach, while permitting entities to follow a more simple approach (that is, combining Bucket 2 and Bucket 3) if appropriate.

Alternative 2 – Unit of evaluation difference

34. Under Alternative 2, the differentiating factor between Bucket 2 and Bucket 3 is not a “deterioration principle” difference. Rather, the difference between Bucket 2 and Bucket 3 is whether the asset that qualifies for recognition of lifetime losses is evaluated (a) collectively (in which case it would be classified in Bucket 2) or (b) individually (in which case it would be classified in Bucket 3).⁷
35. Alternative 2 would rely on an entity’s current approach to evaluating financial assets for impairment, and simply provide that individually evaluated financial assets that qualify for lifetime losses are classified in Bucket 3.

⁷ Bucket 1 would still represent financial assets that do not qualify for recognition of lifetime losses, including both those evaluated collectively and those evaluated individually.

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36. Some think Alternative 2 would leverage an entity’s existing loan review procedures and provide valuable information regarding truly problematic financial assets that the entity analyzes individually. Those that favor this alternative think the benefits of providing this information outweigh the costs, particularly because the incremental “cost” of this approach would be relatively minor as it builds on an entity’s existing loan review processes without imposing additional review processes on the entity. Those who do not support this alternative note that some credit risk managers have told us that even in portfolios of homogenous assets, credit analysis (such as tracking of delinquency statistics) is undertaken at an individual asset level and, as a result, can be relevant for all assets and thus is not an appropriate basis for differentiation.
37. Finally, some may favor this approach because Bucket 3 would be similar to the loans qualifying as FAS 114 impaired loans (as codified in ASC 310-10-35). In addition, this alternative might be similar to the current guidance in IAS 39.88, which states, “Impairment losses recognised on a group basis represent an interim step pending the identification of impairment losses on individual assets in the group of financial assets that are collectively assessed for impairment. As soon as information is available that specifically identifies losses on individually impaired assets in the group, those assets are removed from the group.”
38. Others prefer Alternative 1 because they think it provides an additional element of decision-useful information and provides a conceptually superior approach because it classifies loans into three buckets on the basis of credit deterioration.

Alternative 3 – Merge Bucket 2 and Bucket 3

39. Under Alternative 3, Bucket 2 and Bucket 3 are not differentiated based on a credit deterioration principle (like Alternative 1) or unit of evaluation (like Alternative 2). Because the measurement approach is the same for Bucket 2 and Bucket 3, there is no way to differentiate between these buckets. As a result, Bucket 2 and Bucket 3 would be merged into a single bucket, representing those financial assets that qualify for recognition of lifetime losses and the model would

only have two buckets differentiated by the recognition of credit losses (either less than lifetime or lifetime losses).

40. Those who favor this approach think there is a limited benefit of having a third bucket that is only for information purposes, especially when the measurement attribute is the same for Bucket 2 and Bucket 3, and the timeframe between transfer to Bucket 3 and writing off the asset may be short.

Question to the boards

2.1 - As it relates to distinguishing between Bucket 2 and Bucket 3, which alternative described in paragraph 24 do the boards favor, if any?