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Project	**Financial Instruments: Impairment**		
Paper topic	Application of credit deterioration model to loans		
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Purpose of the Paper

1. The purpose of this paper is to discuss the application of the impairment model being considered by the boards to consumer (retail) loans and commercial and institutional loans. Consumer loans include residential mortgages, credit card lines, and consumer instalment loans. Commercial and institutional loans include commercial and industrial loans (and other facilities), commercial lease financings, commercial real estate loans, and loans to foreign commercial and sovereign entities.

Background

2. A model that is based on credit deterioration of loans would be applied differently to different classes of loans based on (1) the way such loans are managed and (2) the information available to the creditor to assess the credit deterioration of the financial asset. Feedback received from preparers is that consumer loans and commercial loans are not managed in the same manner. Credit risk management processes for commercial loans use a loan grading system while credit risk

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management processes for consumer loans focus on delinquency as a starting point, but will also look at other factors for credit deterioration.

3. Consumer loans are generally reviewed for credit deterioration in larger pools than commercial loans. Risk management is typically not able, for various reasons including cost/benefit reasons, to review consumer loans (particularly, smaller-balance, high credit quality loans) on an individual basis until a triggering event occurs that indicates that an individual consumer loan may be deteriorating from a credit risk perspective. Instead, lenders assess such credits as part of a pool of similar loans, using historical loss experience adjusted for current conditions. Commercial loans are more likely to be evaluated from a risk management perspective on an individual basis, given the entity specific relationship that the lender may maintain with the borrower. For commercial loans, probabilities of default (PDs) can be readily assigned at the individual loan level and then loans can be managed on a portfolio basis.
4. For commercial loans, risk grading processes and use of PDs are the common approaches to risk management. Consumer loans are typically not assigned risk ratings (however, the staff understands from some institutions that risk ratings are assigned even to consumer loans). PDs are not the primary metric used for consumer loans or for risk assessments by nonfinancial institutions. Rather, delinquency is usually the first sign of credit concern for consumer loans. Therefore, the staff believes that trying to link a probability of default concept to the assessment of all loans for impairment will generally not be workable as it does not align with the most common risk management processes for certain types of assets and entities.

Current credit risk management and loss estimation processes for consumer loans

5. Credit risk management of consumer loans considers a variety of factors based on risk management policies established by the lender. The assessment of consumer loans focuses on the capacity of the borrowers to repay the loans and an assessment of current and potential factors that could impact that capacity.

Factors considered by lenders in assessing and measuring impairment of consumer loans include the following:

(a) Factors reflecting the credit profile of the borrower

 (i) Delinquency of the borrower (i.e., past due status)

 (ii) FICO scores or similar risk scoring systems

 (iii) Data regarding the borrower's ability to pay

 (iv) Bankruptcy filings

(b) Collateral values (e.g., home prices, vehicle values, equipment residual values)

(c) Economic drivers, primarily unemployment rates.

6. Consumer loans are segmented into homogeneous risk groupings that permit management to assess how similar groups of loans have performed historically. The process of grouping and considering historical performance of portfolios as well as current performance permits lenders to forecast how the portfolios are likely to perform in the future. Subsequent to origination, lenders use techniques to forecast delinquency and losses over time to reflect current conditions. Such techniques use historical data as a starting point, but is updated to reflect current data and trends.

7. The specific techniques used may differ depending upon the lending institution. For example, some institutions may look only to simple average historical losses (e.g., average loss rates representing net charge offs in the U.S.) as a starting point, while more sophisticated institutions may use migration analysis that can be based on vintage data or delinquency roll rate data. They also may use "roll to worst" analyses to test the accuracy of their previous estimates and underlying triggers. For example, a test can be performed by analyzing the amount of cash ultimately collected for loans that reach a certain delinquency status (such as 60 days past due). If an entity determines that 50% of loans that are 60 days past due ultimately are not collected, it considers this data in determining the allowance.

8. Determination of impairment losses also considers the value of collateral in terms of estimating the ultimate loss from a borrower default. That is, in determining the amount of losses expected to occur (that is, loss given default), lenders would consider the existence of any collateral, the current value of that collateral (e.g., residential property values, equipment residual values, vehicle values), and whether projected collateral values will be sufficient to cover potential future losses.

Current credit risk management and loss estimation processes for commercial loans

9. Credit risk management of commercial loans considers a variety of factors based on risk management policies established by the lender. As noted earlier, commercial loans are managed using risk grading processes. The credit risk grade is a metric used by management to evaluate the borrower's credit risk at a point in time. Risk grades are assigned to differentiate loans with differing credit qualities for purposes of applying different credit risk monitoring processes according to credit quality and risk. Grading systems are not uniform and can vary across banks in terms of how many grades are used and the type of credit quality the grade may represent. Ratings are typically assigned (or reaffirmed) at the time of each underwriting or credit approval action. The staff understands that many institutions review credit risk grades at least annually, though this may not be universal practice.
10. As with retail loans, the assessment of commercial loans focuses on the capacity of the borrower to repay the loan and an assessment of current and potential factors that could impact that capacity. The factors below, among others, influence a "credit risk grading" used for credit risk management purposes and enter into management's assessment of commercial credit risk:

    (a) Operating results (i.e. trends and projections in operating results)

    (b) Operational risks

    (c) Industry trends

(d) Management expertise

(e) Asset quality

(f) Leverage and liquidity ratios of the entity

(g) Financial support from a parent entity or other affiliate

(h) Previous experiences lending to the entity

11. The credit risk grade acts as a summary statistic for a particular commercial credit's probability of default. Lenders consider probabilities of default (PDs), loss given default (LGD), and exposure at default (EAD) to determine the appropriate amount for the reserve. The probability of the commercial entity defaulting on its obligations (or migrating to another credit risk grade) can be inferred from various sources, such as internal data on the historical default rates for loans originated by the lender, published data on the historical default frequencies of similarly-rated corporate bonds, or default rates experienced by other banks.
12. Although probability of default has a critical influence on the level of the reserve, ultimately management judgment plays a significant role in the assessment of credit quality. Loss estimation procedures involve qualitative assessments of credit risk as an overly to quantitative factors.

Application of the credit deterioration impairment model to loans

Assessment of Impairment

13. Under a credit-deterioration model, all originated loans will be included in Bucket 1 at initial recognition. Within Bucket 1, for purposes of assessing loans for impairment, the loans may be grouped according to their risk characteristics, as further discussed in AP6C/ Memo 120. As discussed in that paper, when assets are grouped, entities should assemble pools of loans in a manner that facilitates assessment of impairment at a level that is detailed enough to surface the impact of factors that could drive deterioration of the loans in that pool. That grouping of loans would be done in such a way that the pools would share similar risk

characteristics and traits. The staff think this process would be consistent with current processes of creating groups of homogeneous consumer loans as well as any grouping of commercial loans for the purposes of assessment and measurement of impairment losses.

14. Under the decisions reached to date, Bucket 1 will contain loans that have not deteriorated to an extent that results in recognition of lifetime expected losses. As discussed in AP 6B/Memo 119, one possible way to define when to recognize lifetime losses is based on a meaningful deterioration[1] in credit quality of the loan. Accordingly, if the level of deterioration for a specific pool of loans is not significant enough to warrant recognition of lifetime losses, the loans would remain in Bucket 1 and the allowance would reflect the measure of impairment required for Bucket 1 financial assets (further discussed in AP 6A/Memo 118).
15. The process of assessing loans in Bucket 1 for signs of impairment and measuring credit impairment based on losses expected to occur are closely related. In both cases, entities would need to monitor various factors and economic trends that would be indicative of credit deterioration of the loans. In assessing the quality of the loans in Bucket 1 and in measuring impairment losses, management should consider all reasonable and supportable information available to it.
16. Many of the factors that would be considered in assessing and measuring impairment losses for loans captured in Bucket 1 are the same factors that would need to be considered in determining whether a transfer to Bucket 2 is required. However, the staff believes there are certain factors that would be considered when assessing and measuring impairment losses for loans captured in Bucket 1 that do not relate to deterioration since initial recognition. That is, for loans captured in Bucket 1, the staff think entities should consider changes in the nature and volume of the portfolio when loans are originated or purchased in order to determine the appropriate Bucket 1 measure. For example, the staff think lenders

[1] This is one possibility in Alternative 1 of AP 6B/Memo 119. A *meaningful deterioration* in credit quality is just one alternative for expressing the point at which it is appropriate to shift from measuring impairment losses based on a bucket 1 measure (less than losses expected to occur over the remaining lifetime of the financial assets) to bucket 2 (a lifetime loss measure). Use of the term meaningful deterioration as an expression of the appropriateness to recognize lifetime expected losses in the remainder of this paper is for illustration purposes only.

should consider changes in underwriting standards as new loans are originated, changes in lending policies (for example, on the consumer side, a more or less aggressive approach to soliciting credit card borrowers could affect expected losses), and changes in concentrations (for example, newly originated large magnitude commercial loans may have a material influence the risk concentration level of the portfolio.) Past loss experience may not be an indication of future losses if there are changes in underwriting standards, lending policies, etc.

17. The staff think that significant management judgment will be required in determining when a change in circumstances as evidenced by a variety of factors constitutes a meaningful deterioration requiring a shift to lifetime expected loss recognition rather than a change in the measure of impairment for the pool within Bucket 1.

Transfers to Bucket 2 or Bucket 3 (i.e., when lifetime losses are required to be recognized)

18. With respect to when lifetime expected losses are appropriate, if the boards decide as discussed in AP 6B/Memo 119 (or AP 6C/Memo 120) that a transfer into Bucket 2 (or Bucket 3) should occur when a meaningful deterioration in credit quality has occurred, the boards could elaborate on that principle by discussing what this means specifically for loans. For example, the staff think the boards could consider indicating that:
    a. A meaningful deterioration has occurred if there are potential weaknesses in terms of the borrower's (commercial entity's[2] or individual's) ability to satisfy the loan, which may result in further deterioration in credit quality or the capacity to repay if left uncorrected, as a result of an assessment of specific factors and indicators relevant for the asset class.

[2] This is similar to concepts underlying the "special mention" classification as discussed in the loan classification guidance issued by the U.S. Banking Agencies. As defined within regulatory guidance, a Special Mention asset "has 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."

19. The general principle would be accompanied by indicators (AP 6B/Memo 119) and factors to be considered in assessing whether lifetime losses should be recognized.
20. For both consumer and commercial loans, the purpose of the indicators is conceptually, to capture deterioration of repayment in its earliest stages and practically, to provide specific items to consider in assessing when deterioration in the borrower's capacity to repay is significant enough to warrant recognition of losses expected to occur over the remaining lifetime of the loans.
21. The staff think that the factors and indicators that are relevant in assessing loans include the following:

    a. Economic factors:

        i. For consumer loans:

            1. Current and projected changes in unemployment rates that may create an expectation of future delinquency and ultimate default

            2. Current and projected changes in national and local economic and business conditions that may indicate an expectation of future delinquency and ultimate default. (For example, a recent, deteriorating trend in the local economy may adversely affect borrowers and result in the bank charging off loans at a rate higher than its historical loss experience. The more specific that the conditions are to an individual portfolio will provide for more accurate assessments and estimates.)

            3. Current and projected factors indicating declining collateral values creating an expectation of an economic disincentive for a borrower to perform on a loan (e.g., property values for loans secured by residential property)

ii. For commercial loans:

1. Current and projected changes in national and local economic and business conditions that may create an expectation of the inability of the borrower to repay.
2. Current and projected industry trends that may create an expectation of the inability of the borrower to repay (For example, a recent, deteriorating trend in a particular commercial industry may adversely affect borrowers and result in the bank charging off loans at a rate higher than its historical loss experience. The more specific that the conditions are to an individual portfolio will provide for more accurate estimates.)
3. Factors affecting collateral values

b. Current and expected changes in factors reflecting the credit profile of the borrower

i. For consumer loans:

1. Delinquency of the borrower (i.e., past due status)
2. FICO scores or similar risk scoring systems
3. Data regarding the borrower's ability to pay
4. Bankruptcy filings

ii. For commercial loans:

1. Operating results of the entity (i.e. trends and projections in operating results, such as declining revenues or margins)
2. Management expertise
3. Operational risks
4. Asset quality

5. Increased leverage or decreasing liquidity (as evidenced by leverage and liquidity ratios of the entity)
6. Financial support from a parent entity or other affiliate
7. Other factors specific to the entity (e.g., pending litigation).

22. The staff notes that some of the factors listed in item (b) related to the credit profile of the borrower, such as delinquency for consumer loans, may not necessarily be early-warning or "forward-looking" indicators of deterioration in credit quality but rather evidence that deterioration has already occurred.
23. Additional discussion of application of the transfer principle and the relevant indicators to consumer and commercial loans is included in the paragraphs below.

Consumer loans

24. Given the nature of consumer lending, delinquency data is the most widely available source of information of a borrower's capacity to repay a loan. That is, due to the nature and volume of consumer loans and the inability to monitor such loans on an individual basis, delinquency data is the best available information to assess the likelihood of potential borrower default.
25. Delinquency is a universal tool used for management of credit risk of consumer loans. The staff understands that, for consumer loans, delinquency is the primary factor considered when assessing borrower performance, likelihood of payment and, therefore, deterioration of credit quality. While other borrower-specific factors such as credit scores may be heavily considered by some lenders in some jurisdictions, the staff understands that credit scores, such as FICO scores, are not available in all jurisdictions.
26. Therefore, the staff believes the Boards could specify that in assessing whether the transfer to Bucket 2 is appropriate, whether a meaningful deterioration in credit quality has occurred should consider delinquency status (that is, number of days past due) and projected delinquencies for consumer loans. The Boards could

indicate this is a general indicator to be considered in concert with other indicators. In addition, the boards could specify as a backstop a bright line in terms of number of days past due for recognition of lifetime losses that might be relevant for particular loan types. This could be discussed, for example, within the context of examples or implementation guidance.

27. Some constituents have conveyed that the factors that are most relevant in determining whether there has been a meaningful deterioration may differ for different classes of consumer loans. For example, for retail mortgage loans, while delinquency is a primary factor considered, other significant factors include current collateral values and current FICO scores (in the U.S.). For credit card lines and auto loans, as stated earlier, the staff understands that delinquency is the driving factor in assessing the performance of the borrower, but lenders indicate other factors such as bankruptcy and changes in unemployment rates are also key considerations in assessing the credit quality of these types of loans.
28. In addition, the staff think that the consideration of delinquency should not focus only on the absolute number of days past due but also a consideration of the *extent* of deterioration that would indicate that recognition of lifetime losses is appropriate because such deterioration is consistent with the meaningful deterioration in credit quality being used as a principle. For example, a bright line of 60-days past due might be a strong indicator of deterioration for certain loan types, while a much lower number of days past due might be an indicator of deterioration of other loan types. Lenders should consider loan characteristics in making this assessment. For example, loans that by their nature have higher risk characteristics, such as non-traditional structures or sub-prime loans, would need to be evaluated differently than traditional structures or loans to higher credit quality borrowers. Ultimately, the staff think there is no specific delinquency trigger that can be universally applied for purposes of comparability as there will always be idiosyncratic features that will make such a comparison difficult. In addition, some staff members point out that a certain delinquency status can have a different meaning across jurisdictions with respect to the performance of the borrower.

29. Further, the staff think the guidance should avoid an over-reliance on one factor, such as delinquency, as this may not produce the appropriate results in all cases. For example, loans that are structured to have specific payment terms, such as back-loaded payment structures or balloon payments, which make it possible for borrowers to keep the loans current in early years, loans that may have "cures" for delinquency, or practices such as providing extensions[3] or re-aging[4] that keep borrowers from reaching certain delinquency levels, may distort the outcomes if delinquency is considered in isolation.
30. The staff think that while delinquency is an important indicator of credit quality of consumer loans, it is a lagging indicator. Therefore, the staff think the model should require the necessary discipline of considering other factors, such as overall macroeconomic conditions, employment statistics, collateral value deterioration, and economic projections from currently available information, to determine whether they indicate a meaningful deterioration has occurred *before* a specific trigger (such as a specific past due status) is reached to achieve earlier loss recognition. That is, management will need to evaluate the various factors and determine the point at which a meaningful deterioration has occurred with the objective of highlighting potential problems before actual losses manifest, as guided by the transfer principle and indicators discussed above, in AP 6B / Memo 119 and earlier in this paper.
31. For example, in some situations, borrowers may be performing, but economic factors may indicate that there has been a meaningful deterioration for a particular pool or loan. For example, consider a situation in which a lender identifies a pool of loans to borrowers in a specific geographical location that has experienced an economic downturn and significant housing price decreases. While borrowers may still be performing at the time of assessment, the lender may need to consider whether the decline in home prices creates a significant increase in the risk of

[3] A loan extension agreement extends the time a borrower has to pay off a loan. This agreement is between the lender and borrower and sets out the amount of the loan, date of original loan and its maturity date and the new maturity date of the loan.

[4] Re-aging refers to the process of classifying a previously delinquent loan as current. Typically an account can be re-aged if certain criteria are met, including that there are three consecutive on-time payments.

borrower default. That is, the lender would need to consider whether, within the relevant jurisdiction, the borrower may no longer have an economic incentive to perform on the loan. Based on this assessment, the lender may conclude that the subset of the loans in that local region result in a transfer to Bucket 2 (ie recognition of lifetime expected credit losses).

32. Identifying indicators of deterioration in this manner should serve to achieve earlier recognition of impairment losses for consumer loans relative to an approach that is based on an assessment of objective evidence of impairment. The staff understands that currently in the U.S., largely due to specific regulatory guidance on timing of charge offs for retail credits, there is typically a short timeframe between identification of a consumer loan as having evidence of impairment and write off of that loan.[5] That is, typically, consumer loans are either performing or show specific evidence of impairment requiring write-off within a short timeframe. An interim step of recognition of lifetime losses for certain consumer loans would seem to be achievable within the model by focusing on early indicators of credit deterioration.
33. In addition, for both consumer and commercial loans, the point at which recognition of lifetime losses should also be required should consider internal risk management processes that cause management to monitor or manage the loan differently.

Commercial loans

34. As discussed earlier, given the nature of commercial lending, delinquency is not the primary tool used to manage credit risk. Instead, commercial credits are monitored and managed on an individual basis, and relative to consumer loans significantly more information is available to lenders to assess credit risk on an

[5] The U.S. Banking Agencies have issued specific guidelines required to be applied by regulated institutions for recording charge-offs (write-offs) of retail credits. The guidelines specify that charge off is required for closed-end retail loans (such as instalment loans) that become past due 120 cumulative days, open end retail loans (such as credit card lines) that become past due 180 cumulative days from the contractual due date. Specific rules exist for a variety of situations, including for loans in bankruptcy, fraudulent loans, and loans to deceased persons. Any board member that would like to receive a copy of the U.S. Banking Agencies' Retail Credit Policy should contact the staff.

ongoing basis based on factors related to the borrower's condition. Such information feeds into loan grading systems.

35. Previous memos (such as AP 4C/Memo 111 from the September 2011 joint meeting) discussed possible alternatives for selecting a point at which lifetime losses should be recognized for commercial credits considering the risk grading process. For example, one possibility discussed in AP 4C/Memo 111 is to consider characteristics of loans that are downgraded to non-investment-grade status. As discussed in paragraph 45 of AP 4C/Memo 111, for loans at the higher end of the non-investment grade spectrum (i.e., BB), S&P rating category definitions states that those borrowers would currently have the capacity to meet their financial commitments but are vulnerable in the near term to meet them, while Moody's describes these loans as being subject to substantial credit risk. In addition, similar notions are incorporated into regulatory guidelines which focus on the risk of not collecting all contractual cash flows. Those underlying concepts, which focus on the increasing vulnerability of the company's ability to meet its obligations, in addition to credit risk indicators, could be used to support the principle describing the meaningful deterioration for recognition of lifetime losses.
36. The indicators in AP 6B/Memo 119 and the factors discussed earlier in this paper are designed to focus attention on emerging risks of a commercial entity that may affect the borrower's capacity repay the loan. That is, the focus on negative operating trends, balance sheet trends (e.g., increasing leverage), increasing or changing risks faced by the company, and factors relevant to the industry in which the entity operates as well as overall economic conditions should serve to highlight potential problems that indicate a meaningful deterioration in credit risk before actual shortfalls in cash flows manifest.
37. In addition, as discussed earlier, the assessment should consider internal risk management processes that cause management to monitor or manage the loan differently. Credit risk management of commercial loans typically become more focused and deeper the lower the respective credit risk. As uncertainties about the future prospects of a company increase, entities start to pay more attention to the

specific circumstances of a company's deterioration, potential solutions and expected recoveries if a default was to occur. For example, as loans deteriorate from investment grade to non-investment grade status, uncertainty about collecting contractual cash flows increases so that loans are likely to be closely monitored, ring-fenced at a portfolio level and specific interventions may occur.

38. When the probability of default rises beyond a certain level, as dictated by entity-specific and/or regulatory standards, commercial loans may be placed on a 'watchlist'. Commercial loans may be put on a watchlist for different reasons and that term can mean different things in different jurisdictions. For example, a loan can be placed on a watchlist due to a severe drop in the credit risk grade or a *potential* change in the credit risk grade or merely due to the magnitude of the loan. During outreach, many constituents agreed that the assignment of loans to watchlists (where the watch list captures heightened credit risk) should be considered, but should not be a sole determinant of heightened credit risk, due to the diversity in their application.

39. If the boards were to decide on Alternative 2 in Issue 1 of the board paper 'Principle of transfer' (IASB AP 6B/ FASB Memo 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.

Questions for the Boards
1. Do Board members agree with the discussion of the application of the impairment model to consumer loans and commercial loans, which would require an evaluation of all factors and indicators *to determine whether a meaningful deterioration has* occurred?

> 2. In addition to a discussion of when to recognise lifetime losses and the indicators, would Board members like to include a bright line that indicates a presumption that a meaningful deterioration has occurred (e.g., based on reaching a specific number of days past due for consumer loans and/or a reaching a particular credit risk rating or PD level for commercial loans expressed using underlying and familiar concepts of regulatory guidance and rating agency guidance)? If not, would the Board members like to include them (or one of them) as an indicator instead?

Measurement of credit impairment losses on a collective basis in Bucket 1 and Bucket 2

40. With regard to measurement of credit impairment losses, the boards' tentative decision in March 2011 was that loss rates may be used to achieve the measurement objective of expected value.[6] Accordingly, for both consumer and commercial loans, if loss rate techniques are used, the staff believe that entities may use those techniques that are currently employed for measurement of credit impairment losses for consumer loans, as discussed in the background section as long as it is consistent with the measurement objective.
41. If historical loss experience is the basis for estimating impairment losses for loans, entities are currently required, and would continue to be required, to adjust historical experience to reflect a variety of qualitative factors. Under the current model that the boards are considering, entities would consider all reasonable and supportable information in determining the appropriate adjustments to historical experience. The staff think management should consider all information relevant to the collectibility of the financial assets, including information about past

[6] The Summary of Decisions Reached/Update for the March 22, 2011 joint Board meeting states, "At this meeting, the Boards tentatively decided that expected losses should be estimated with the objective of an expected value. They tentatively decided that the final standard will explain that an expected value identifies possible outcomes (or a representative sample of the possible outcomes), estimates the likelihood of each outcome, and calculates a probability-weighted average. However, the final standard will acknowledge that other appropriate methods could be used as a reasonable way to achieve the objective of an expected value. An example of a suitable method would be a loss rate method and the use of probabilities of default, loss given default, and exposure at default data. In performing this calculation, an entity must not ignore observations and possibilities that are known."

events, current conditions, and reasonable and supportable forecasts. Accordingly, management should determine an appropriate adjustment to capture the effect of each qualitative factor, which may differ from the adjustment made for the effect of that factor on its loan portfolio in the past.

42. Another issue with respect to measurement of impairment losses relates to the consideration of collateral. In specific Topic 3 of AP6E/Memo 122 addressing debt securities outlines that issue and questions whether the boards wish the staff to pursue whether the fair value of the collateral (for instruments that are collateral-dependent) can be used as a reasonable way of achieving the expected value objective.

Question for the boards
Do board members agree with the approach described in paragraphs 40-41 for measurement of impairment losses under the expected value objective?