

STAFF PAPER

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Project	Financial Instruments: Impairment		
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Purpose of this Paper

1. The purpose of this paper is to discuss the application of the three-bucket impairment model being considered by the boards to publicly tradable debt instruments (i.e., referred to as “debt securities” throughout this paper).

Background

2. The discussions to date regarding the three-bucket model have revolved around commercial loans. The staff is aware that application of such a model to other types of instruments may present challenges not yet considered by the boards.
3. One of the main concerns we heard from some users was the ability to apply an expected loss model to debt securities because of:
 - (a) The lag time in data collection – i.e. it may take months between an event taking place and information becoming available to the holder (e.g., through receipt of periodic financial statements) about how that event impacts the borrower; and,

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- (b) An entity holding such a debt security is further away from the facts, so they do not have access to the detailed information that an expected loss model may require.

In other words, we have heard that due to a lack of a bilateral relationship with the issuers of debt securities, it is much more difficult to get granular credit information on a timely basis to apply an expected loss model appropriately. Rather, entities may just look to external ratings when doing their own credit analysis.

4. The staff notes that the information set to be used in an expected loss model is all reasonable and supportable information, including forward-looking forecasts and estimates. As a result, an entity would not need to be exhaustive when analyzing credit risk. In the extreme, the main pieces of information available to perform an impairment analysis may simply be the current price and external credit ratings (if any).
5. This paper raises a number of incremental topics with the three-bucket model that are specific to debt securities. They are as follows:
 - (a) Topic 1 - The existing practice of managing and evaluating debt securities on an individual instrument basis (as opposed to grouping on the basis of shared risk characteristics), and the existence of fair value information for debt securities
 - (b) Topic 2 - Potential indicators for when the recognition of lifetime losses is appropriate for debt securities
 - (c) Topic 3 – The use of an “expected value” (i.e. probability-weighted mean) notion in estimating losses.
6. A number of these topics have been raised by constituents as the three-bucket model has been developed. Further, these topics were validated in a number of preparer outreach sessions performed in October and November of 2011. However, it is also noted that staff has spoken to some constituents who have little incremental concern, if any, applying the same model to debt securities.

7. This paper briefly addresses each of these topics. In some circumstances, alternatives are presented for the boards to consider in how the three-bucket model may be applied to debt securities. In other circumstances, the boards are asked to affirm the staff's interpretation of how the model would apply in such circumstances.

Summary of current impairment guidance for debt securities

8. As an appendix to this paper, the staff have provided a summary of current impairment guidance for debt securities under both U.S. GAAP and IFRS.

Topic 1: The existing practice of managing and evaluating debt securities on an individual instrument basis (as opposed to grouping on the basis of shared risk characteristics), and the existence of fair value information for debt securities

9. The staff understand that preparers typically evaluate debt securities on an instrument-by-instrument basis when evaluating credit impairment. This approach is based on the belief that, in most cases the security represents a unique (or bespoke) instrument that is worthy of individual evaluation.
10. Moreover, from an investment management perspective, while a portfolio of debt securities may be reviewed by upper management on an aggregated basis, the day-to-day management of the portfolio typically entails analysis at an individual security level. Analysis at the individual security level takes place particularly given an entity's ability to exit the position via a relatively liquid marketplace (which provides the opportunity to liquidate a position with relatively minor transaction costs). The ability to easily exit such positions creates an incentive for management to regularly monitor the individual security to determine whether they should exit the position. This may differ from entities who originate loans, for which the day-to-day management of the loans may be at the pool level, and the ability to easily exit the position (e.g., through a sale) is more restrictive.

11. After assessing debt securities individually for impairment, entities do not typically group the securities at a more aggregated level (e.g., all corporate bonds issued by technology companies or all corporate bonds with an A- credit rating). While IAS 39.64 requires such instruments to be included in groups and collectively assessed, in practice the staff understand that entities often conclude that it does not hold a group of assets with similar risk characteristics, in which case the collective assessment is not performed (consistent with IAS 39.AG87).
12. In limited circumstances, entities may group individual securities that have shared risk characteristics, such as when a shared risk characteristic is of particular concern for the entity. For example, some entities may aggregate sovereign debt securities, residential mortgage backed securities, or troubled financial institutions receiving governmental support if the securities are similarly affected by a shared risk characteristic. The purpose of this grouping is primarily to identify the population of securities affected by a particular shared risk characteristic, and not necessarily to evaluate a deterioration in credit risk (as the three-bucket model may infer). In practice, the measurement of impairment allowance is performed at the individual security level under current guidance. That is, while an entity may group or aggregate certain financial assets for risk management purposes and to assist in identifying whether a credit impairment exists, the measurement of credit impairment is still performed on an individual instrument basis.
13. For example, assume that an entity holds a number of guaranteed residential mortgage backed securities (i.e., so-called “wrapped RMBS”). If a particular guarantor was having financial difficulties, an entity might group those RMBS securities that are guaranteed by the problematic guarantor. In that case, the entity might assess whether performance by the guarantor is expected and utilize that information in measuring credit impairments on the individual RMBS that are guaranteed by the problematic guarantor.
14. The staff considered why grouping of certain commercial loans may be viewed by practitioners as appropriate, while practitioners may view the grouping of debt securities as inappropriate (that is, why practitioners may believe commercial

loans can be included in relatively homogeneous pools, while debt securities often cannot). Practitioners noted that loans are issued within the context of a specific loan program established by the entity. The program inherently establishes the boundary of what the entity views as a “similar” series of lending activities. Such programs are generally designed with the ultimate business strategy of collecting the contractual cash flows from the borrower. This differs from the approach for debt securities, which are frequently held to either maximize the entity’s total return or manage its liquidity.

15. As a result, when compared to loans, debt securities differ in that (a) they do not fall into clearly defined boundaries established by management such that they can be viewed as being sufficiently similar and (b) the timeframe over which management expects to hold a debt security is often only a portion of the total tenor, as opposed to loans where management often expects to hold the loan until maturity.

Staff analysis

16. The staff would not expect the three-bucket model to result in a change to the current practice of evaluating relatively unique financial assets on an instrument-by-instrument basis (i.e., the accounting guidance would not result in a more aggregated level of analysis than is currently performed for risk management purposes). Nor would we want to discourage individual evaluation if it enables the best assessment of expected losses to be made (that is, a more granular analysis).
17. Provided that entities are granted the flexibility to evaluate impairment on an individual asset basis, the staff would expect that entities would first evaluate securities individually for purposes of determining whether recognition of lifetime losses is required. Having said that, the staff does not intend to require that entities evaluate debt securities on an individual instrument basis, unless such a security was individually significant to the entity or there was no appropriate grouping for the security (in which case, we believe the entity would be required to evaluate the security individually). If the entity holds multiple “lots” of the same debt security,

the staff expect that securities would be evaluated on a lot-by-lot basis to the extent the creditworthiness of the obligor differed materially at the time individual lots were purchased.

18. In evaluating whether an individual security has met the criteria for recognition of expected lifetime losses (i.e., as a consideration in evaluating impairment), the staff believes that an entity would be expected to consider relevant market information, such as changes in the fair value of the debt security. As a result, the staff expect that an entity would consider in its impairment evaluation whether the fair value of the debt security is below the cost basis of the security (which may indicate that a credit deterioration has taken place since initially recognizing the instrument). In most circumstances, the staff think that if the fair value of the debt security was greater than the amortized cost basis, an entity would be able to conclude that the recognition of lifetime losses is not required.
19. As it relates to the topic of grouping, the staff does not believe this topic raises incremental issues that need to be considered in developing the three-bucket model. That view is based on the fact that the grouping principles (AP 6C / Memo 120):
 - (a) Permit an entity to individually evaluate whether it is appropriate to recognize lifetime losses for a debt security.
 - (b) Recognize that not all financial assets will have a corresponding group of financial assets with shared risk characteristics and, thus, some financial assets may not ultimately be included in a group.
 - (c) Require that when a financial asset does not have a corresponding group of financial assets with shared risk characteristics, that the entity individually evaluate whether it is appropriate to recognize expected lifetime losses (if it hasn't already done so).

Staff view

20. The staff does not think the practice of managing debt securities on an instrument-by-instrument basis or the existence of fair value information for debt securities

raises incremental issues that need to be considered in developing the three-bucket model. The staff note that the next topic addresses the use of fair value information as an indicator for when recognition of expected lifetime losses is appropriate.

Topic 2: Potential indicators for when it is appropriate to recognize lifetime losses for debt securities

21. In practice today, the staff understand that the primary focus on the impairment analysis for debt securities is analyzing individual securities to determine whether the security has experienced a change that provides evidence that a loss has been incurred. Under both U.S. GAAP and IFRS, that analysis largely focuses on current conditions, as opposed to expected future conditions. While the existing model is an “incurred loss” model, certain guidance in U.S. GAAP does indicate that entities should consider “reasonable and supportable forecasts” in assessing whether there has been a credit impairment.¹

Staff analysis

22. At concept, the analysis to determine whether the recognition of lifetime losses is appropriate under the three-bucket model (as discussed in IASB AP 6B / FASB Memo 119) may be similar to the analysis taking place under the current guidance, although analysis under the three-bucket model would use a broader information set. For example, while existing guidance relies heavily on current conditions, under the three-bucket model an entity’s analysis would be more forward-looking. The analysis 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).
23. As a result of this more forward-looking analysis, the staff would expect entities to rely more heavily on professional judgment in assessing impairment than under

¹ Paragraph 320-10-35-33G

the current guidance because under the current guidance more tangible indicators of impairment may be considered necessary to recognize a credit impairment.

Staff view

24. Consistent with the evaluation process for retail loans, commercial loans and other instruments under the impairment model, the staff believe that significant management judgment will be required in determining whether a change is significant enough to warrant transfer to Bucket 2 (and recognition of expected lifetime losses).
25. At a minimum, the staff believe that the three-bucket model should include indicators that suggest when recognition of lifetime losses is appropriate. The staff built those indicators from existing guidance, and the indicators have been incorporated in the list of indicators provided in IASB AP 6B / FASB Memo 119.
26. Additionally, the boards could choose to include a rebuttable presumption regarding whether it is appropriate to recognize lifetime losses when the fair value of a debt security is less than the amortized cost basis of the security (i.e., what some refer to as “underwater”) by some defined percent (or by some defined percent for some specified period of time). Such an approach would leverage the availability of fair value information (which is less frequently available for loans), and potentially increase the level of comparability with which the deterioration principle is applied. Some, however, do not believe such a presumption is appropriate (even if rebuttable) because it would be a “bright line” and because fair value could fall below amortized cost for reasons other than credit impairment such as due to changes in liquidity premiums.

Questions to the boards

2.1 - Having considered the application of the three-bucket model to debt securities, do the boards have any additional comments regarding the indicators that the staff have articulated in AP 6B / Memo 119?

2.2 - Do the boards wish to include a presumption that if the fair value of the security is less than a specified percentage of the amortized cost basis (or less than a specified percentage of the amortized cost basis for some period of time), then recognition of lifetime losses is presumed to be appropriate? If so, what percentage (and timeframe, if any) would the boards like to utilize? Should that presumption be rebuttable?

Topic 3: The use of an “expected value” (e.g. probability-weighted mean) notion in estimating losses

27. With regard to measurement of credit impairment losses, in March 2011, the boards reached a tentative decision that expected losses should be estimated with the objective of an “expected value.” A pure expected value identifies possible outcomes, estimates the likelihood of each outcome, and calculates a probability-weighted average. At that time, the boards acknowledged that other appropriate methods could be used as a reasonable way of achieving the expected value objective, including a loss rate method and the use of probabilities of default, loss given default, and exposure at default date. The proxies identified in March were largely related to portfolios, as opposed to individually evaluated financial assets. However, the boards at that time established the same measurement objective for all financial assets subject to impairment accounting.
28. Under current practice, many entities do not calculate an “expected value” (i.e., a probability-weighted mean) when measuring an impairment loss under either U.S. GAAP or IFRS. U.S. GAAP guidance utilizes a “best estimate” notion, which some may interpret as a “mean” and some may interpret as “most likely outcome,”

but in practice the staff understand that it is most often interpreted as “most likely outcome.”

Staff analysis

29. In the absence of additional proxies being provided by the boards, given the tentative board conclusions, the staff believe the following:
- (a) That there will be a measured impairment allowance based on an expected value notion for individually identified financial assets that do not meet the criteria for recognition of lifetime losses and that do not have a corresponding “group” for collective assessment and measurement.
 - (b) That a “most likely outcome” notion cannot be used as a proxy for “expected value,” as “expected value” requires consideration of a *sample* of the complete distribution (see clarification in paragraph 30 below).
 - (c) That measuring lifetime losses based on the fair value of collateral for a collateral-dependent instrument is not permissible, as it is inconsistent with the expected value notion.²
30. In the limited outreach performed by the staff in October and November 2011, the staff heard concerns from some preparers regarding the requirement to consider all potentially relevant scenarios and the inability to rely on the fair value of collateral for collateral-dependent instruments. One particular concern relates to what auditors and regulators will require of entities who estimate the impairment allowance using something other than a full probability-weighted “mean.” For example, some preparers question whether auditors and regulators will essentially require a full probability-weighted “mean” analysis to validate that a non-specified proxy is “reasonable.” This feedback is consistent with the March 2011 staff presentation to the boards of issues related to (a) the practical difficulties with

² This practical expedient could be considered inconsistent with the “expected value” notion because it is based on the spot market value of the collateral, and not based (for example) on a probability-weighted forecast of future collateral values over a probability-weighted range of time frames when the collateral may be liquidated to satisfy the obligation.

using an expected value notion and (b) the relevance of expected value measures for individual instruments (refer to paragraphs 16-21 in the March 2011 AP 4B / Memo 80). The staff note, however, that as explained in paragraph 42 of AP 4B / Memo 80 (March 2011) the boards had agreed that the final standard will clarify, “...in practice a concrete estimate of an expected value would not require the use of every single possible outcome. Rather, in the case where there are many possible outcomes, a representative sample of the complete distribution can be used for determining the expected value of the credit loss. In identifying that sample, the entity would need to take into account only the information that is available about the outcomes. It would not have to (and should not) make up anything else.”

31. Without revisiting the March 2011 decision on the “expected value” notion, the boards could decide to provide further application guidance as to other appropriate methods that could be used as a reasonable way of achieving the expected value objective (in addition to a loss rate method and the use of probabilities of default, loss given default, and exposure at default date).³ Conversely, the boards may decide that such application guidance is not needed, or that certain methods are *not* (in fact) reasonable ways of achieving the expected value objective.

³ For example, using solely that guidance, an entity could potentially use publicly available default statistics on a “by-rating category” basis. In such circumstances, however, the entity would also need to develop estimates for loss given default.

32. Some staff think that if the boards have established a clear objective of what an entity should measure, that should give preparers sufficient guidance. Other staff think more detailed guidance would be helpful.

Questions to the boards

3.1 – For measuring the impairment allowance on an individual financial asset basis (as opposed to a pooled or grouped basis), do the boards wish to further pursue providing application guidance regarding appropriate methods that could be used as a reasonable way of achieving the expected value objective?

3.2 - If yes to question 3.1, when measuring the impairment allowance on an individual financial asset basis, do 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? If so, what additional information would the boards find useful in evaluating such an approach?

3.3 - If yes to question 3.1, when measuring the impairment allowance on an individual financial asset basis, do the boards wish the staff to pursue whether an entity should be permitted to exclude from the “expected value” calculation those scenarios for which the likelihood of occurrence is “remote”? If so, what additional information would the boards find useful in evaluating such an approach?

Appendix A – Summary of current impairment guidance for debt securities

1. This appendix outlines current guidance on the impairment of debt securities first under U.S. GAAP and then IFRS.
2. Unlike the U.S. GAAP guidance for loans (Topic 310), Subtopic 320-10 (formerly FAS 115 as amended by FSP 115-1 and FSP 115-2) prohibits the use of a general allowance for unidentified impairment in a portfolio of securities. Rather, debt securities are evaluated for impairment on an individual instrument basis. An entity determines whether a decline in fair value below amortized cost basis is “other than temporary” utilizing a series of impairment indicators.⁴
3. If the decline in fair value is considered “temporary,” it is not recognized in earnings. If the decline in fair value is considered “other than temporary,” the amount recognized in earnings depends on the likelihood of sale of the security. That is, if the entity has decided to sell the security (or it is more likely than not that the entity will be required to sell the security before recovery of the cost basis), the measured impairment amount charged to earnings is the entire difference between amortized cost and fair value as of the balance sheet date. If that circumstance is not present, the measured impairment amount charged to earnings is the amount representing the credit loss. In determining whether an “other than temporary” impairment has taken place, U.S. GAAP provides that an

⁴ Indicators in ASC 320-10-35-33F include (a) the length of time and extent to which fair value has been less than cost, (b) adverse conditions specifically related to the security, an industry, or geographical area (with various examples included), (c) the historical and implied volatility of the security, (d) the payment structure of the debt security, (e) failure to make scheduled principle or interest payments, (f) changes to the rating of the security by a rating agency and (g) changes in the fair value of the security after the balance sheet date. Additional indicators for cost-method equity investments (which may be relevant for the boards’ current discussion) are described in ASC 320-10-35-27, and include (a) a significant deterioration in the earnings performance, credit rating, asset quality, or business prospects of the investee (b) a significant adverse change in the regulatory, economic, or technological environment of the investee, (c) a significant adverse change in the general market condition of either the geographic area or the industry in which the investee operates, (d) a bona fide offer to purchase (whether solicited or unsolicited), an offer by the investee to sell, or a completed auction process for the same or similar security for an amount less than the cost of the investment and (e) factors that raise significant concerns about the investee’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.

entity use their “best estimate” of the present value of cash flows expected to be collected from the debt security.

4. U.S. GAAP also provides specific impairment guidance related to certain debt securities that are issued in the form of beneficial interests (Subtopic 325-40, formerly EITF 99-20). Holders of these securities are required to update their best estimate of cash flows expected over the life of the beneficial interest. If the fair value of the security is less than the amortized cost and the estimated present value of expected cash flows is less than the current amortized cost, the adverse change in cash flows is considered an “other than temporary impairment” and the beneficial interest is written down to fair value, with the impairment loss recognized in earnings.
5. IFRS (IAS 39) provides that a financial asset or a group of financial assets is impaired if (and only if) (a) there is objective evidence of impairment⁵ as a result of one or more events that have occurred after the initial recognition of the asset and (b) the impact of that loss event on estimated future cash flows can be reliably estimated.
6. When there is objective evidence that an impairment loss has been incurred, the amount of the impairment loss recognized depends on the classification of the financial asset. If the debt security is measured at FV-OCI (e.g., available-for-sale investments prior to IFRS 9), the cumulative loss recognized in other comprehensive income as a result of a decline in the asset’s fair value is reclassified from equity to profit or loss as a reclassification adjustment. If the

⁵ Including observable data about the following loss events: (a) significant financial difficulty of the issuer or obligor, (b) a breach of contract, such as a default or delinquency in interest or principal payments, (c) the lender, for economic or legal reasons relating to the borrower’s financial difficulty, granting to the borrower a concession that the lender would not otherwise consider, (d) it becoming probable that the borrower will enter bankruptcy or other financial reorganization, (e) the disappearance of an active market for that financial assets because of financial difficulties, and (f) observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the group, including: (i) adverse changes in the payment status of borrowers in the group or (ii) national or local economic conditions that correlate with defaults on the assets in the group.

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debt security is measured at amortized cost (e.g., particular debt securities under IFRS 9, held to maturity investments under IAS 39, and debt securities classified as loans and receivables under IAS 39), the amount of loss recognized is the difference between the carrying amount and present value of estimated future cash flows, discounted at the original effective interest rate. For securities measured at amortized cost, the carrying amount of the asset can be reduced either directly or through the use of an allowance account.