STAFF PAPER

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REG FASB | IASB Meeting

Project	**Financial Instruments: Impairment**
Paper topic	Staff recommendation for a credit deterioration model

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Introduction

1. The staff have presented a series of papers that strive to more comprehensively frame an impairment model based on credit deterioration. It addresses both (1) the primary conceptual issues and (2) the application of the model to different asset classes. The objective of our team's approach was to allow the staff to develop a more holistic series of recommendations.

2. While not all staff agree on a single recommendation, we would like to point out that all of the staff agree on a number of issues.

Staff recommendation

3. The following table summarises the staff recommendations. The table is followed by a brief summary of why the staff who favour each approach believe that such a series of decisions would result in the most comprehensive and cohesive model.

	Staff View #1	**Staff View #2**
Bucket 1 objective (AP 6A / Memo 118)	EBNM (Expected but not materialised) (Alternative 2 of Topic 1)	Same
Bucket 1 measure of impairment (AP 6A / Memo 118)	To the extent a principle is desired: Shortfalls in cash flows expected to materialise over the emergence period To the extent a bright-line is desired: Shortfalls in cash flows expected to materialise over the next 24 months. (Alternative C1 or Alternative B of Topic 2)	Shortfalls in cash flows expected to materialise over the next 12 months. (Alternative A of Topic 2)

	Staff View #1	**Staff View #2**
Principle for when recognition of expected lifetime losses is appropriate (AP 6B / Memo 119)	Recognise lifetime losses when there has been meaningful credit deterioration since initial recognition.[1] (Alternative 1a of Issue 1)	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*[2] that the contractual cash flows may not be fully recoverable. (Alternative 2b of Issue 1)
Factor differentiating Bucket 2 from Bucket 3 (AP 6C/ Memo 120)	Unit of evaluation difference (Alternative 2 of Issue 2)	Different deterioration principle. Ie Deterioration to a particular level (level to be defined at a later point) (Alternative 1b of Issue 2)
Grouping principles (AP 6C / Memo 120)	As articulated in Issue 1 of paper AP 6C / Memo 120.	Same
For debt securities, include a presumption of when recognition of lifetime losses is appropriate, based on the extent to which amortized cost exceeds fair value? (AP 6E/ Memo 122)	No. (Topic 2, Question 2.2).	Same

[1] The staff who favour this approach believe this alternative could be implemented in a manner consistent with Alternative 2b (Staff View #2) if an entity so chose. This may mitigate the extent of difference perceived between the two staff views.

[2] 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'.

	Staff View #1	**Staff View #2**
For loans, include a presumption of when recognition of lifetime losses is appropriate, based on reaching a specific number of days past due for consumer loans and/or reaching a particular credit risk rating or PD level for commercial loans? (AP 6D/ Memo 121)	No.	Same
Pursue providing application guidance for other acceptable methods to achieve objective of 'expected value' on an individual instrument (AP 6E/ Memo 122)	Yes. Pursue use of fair value of collateral (for collateral-dependent assets) and allowing entities to exclude from the 'expected value' calculation those scenarios for which the likelihood of occurrence is 'remote'. (Topic 3, Questions 3.1-3.3)	No. Do not pursue proxies for expected value for an individual instrument.

Staff View 1

4. The staff who favour 'Staff View 1' believe that these recommendations build on current practice and maintain a principles-based model while also providing sufficient boundaries to aid in comparable application.

5. They believe that having a 'meaningful' deterioration principle for when recognition of lifetime losses is appropriate will allow entities to customise the principle to their business model, system capabilities, and fact patterns. As a result, they believe the 'meaningful deterioration' principle could be implemented

in a manner consistent with the Alternative 2 scenarios of Issue 1 in IASB Agenda Paper 6B / FASB Memorandum 119.

6. Similarly, these staff prefer a principles-based approach for the measurement of Bucket 1. As such, they prefer the unbounded ‘emergence period’ measurement approach based on all reasonable and supportable expectations for Bucket 1. These staff recognise, however, that such an approach may be operationally difficult to implement, in which case they favour a 24-month horizon if a more specific horizon is desired by the boards.

7. These staff favour further considering application guidance for acceptable methods to achieve the objective of ‘expected value’ primarily to avoid such interpretive questions being later decided through audit practice or regulatory oversight.

8. Finally, they believe the benefits of developing a further deterioration threshold for Bucket 3 would outweigh the costs, given that useful information can be provided based on lender’s existing practices in individually evaluating certain loans that have experienced a significant degree of credit deterioration.

Staff View 2

9. The staff who favour ‘Staff View 2’ believe that those recommendations ensure a consistent model for all instruments.

10. They believe that having a ‘meaningful’ deterioration principle will result in a lack of comparability for when entities recognise lifetime losses. Rather they prefer the principle of recognising lifetime losses when there has been a *more than insignificant* deterioration in credit quality since initial recognition AND it is *at least reasonably possible*[3] that the contractual cash flows may not be fully recoverable. This is because it strives to define the ‘meaningful’ deterioration in

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credit quality and reduces the operational complexities. At the same time it takes into account the non-linear risk curve.

11. These staff believe the objective and measurement of the Bucket 1 allowance should be to recognise shortfalls in cash flows expected to materialise in the next 12 months.

12. In addition, they do not favour pursuing application guidance for acceptable methods to achieve the objective of 'expected value' beyond what the boards discussed in the March 2011 meeting.

13. Finally, they believe the benefits of developing a further deterioration threshold for Bucket 3 can give useful information.