Project **Financial Instruments: Impairment**

Topic **Disclosures: Write-off policy, stress testing, credit quality of financial assets and vintage information**

Background

1. In November 2009, the IASB published the exposure draft *Financial Instruments: Amortised Cost and Impairment* (the original ED). Comments on that exposure draft and information obtained through other outreach activities led to the joint publication with the US-based Financial Accounting Standards Board (FASB) of a supplement to that original ED. The joint supplementary document *Financial Instruments: Impairment* (the SD) was issued on 31 January 2011 with a comment period ending 1 April 2011.

2. The SD focuses on the timing of recognition of expected losses. The IASB also published an IASB-only appendix (which is an integral part of the SD for IASB constituents) discussing presentation and disclosure requirements related to impairment accounting. The other presentation and disclosure requirements that were included in the original ED but were less specific to impairment (ie more generally related to credit quality) have not yet been redeliberated and therefore were not addressed in the SD.

Purpose of this paper

3. This paper will provide recommendations and seek guidance from the Board (using the feedback received on the original ED) on the following disclosures proposed in the original ED (the paragraph references refer to the original ED and its Basis for Conclusions):

This paper has been prepared by the technical staff of the IFRS Foundation for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

(a) Write-off policy: paragraph 15(b)

(b) Stress testing: paragraphs 20, B26, BC60;

(c) Credit quality of financial assets: paragraphs 21, B27-B28, BC61; and

(d) Origination and maturity (vintage) information: paragraphs 22, B29, BC62-BC64.

4. The staff notes that there were several comments received on the original ED related to the objective of presentation and disclosures. This will be discussed after the comment period ends on the SD.

Write-off policy

5. In the original ED, the Board proposed that an entity should disclose its write-off policy. A definition of the term 'write-off' was proposed in the original ED. Using the feedback received on the original ED, agenda paper 9 proposes a revised definition for 'write-off'. **Note any decisions made on this topic are subject to any decisions made related to agenda paper 9.**

6. As mentioned in agenda paper 9, the original ED definition was created in order to make sure that once an asset was written off, the possibility of reversal was very small. This was because users had provided initial feedback (prior to the original ED being published) that they did not want to cease getting information about loans on which recoveries were still possible. They also wanted to understand what balances could still 'reverse' once they had been recognised as a use of the allowance account because they believe this information to be important. However, many users believe that 'actual losses' should be reflected before the expiration of all legal means of recovery. For these reasons, the staff recommended in agenda paper 9 that the definition of 'write-off' should not refer to when an entity 'has ceased any further enforcement activities'.

7. Modifying the write-off definition to remove that phrase, however, will mean users cease to get information about these loans as part of the good/bad book

disclosures. In addition, no information is provided to understand what amounts could be 'reversed' after a write-off.

Staff recommendation

8. In order to address users' desire to understand the extent to which recoveries are still possible it would be necessary to provide information about assets that have been written off but on which enforcement activity is still being undertaken. While separate information about these assets was not proposed in the original ED information about these assets would have been included within the general disclosures required as these assets would not have been written off.[1] Staff do not believe that it would be reasonable or particularly informative given the high level of uncertainty to ask preparers to provide estimates of levels of recoveries. However, disclosing the nominal amount of loans written off on which enforcement action is still being pursued would provide users with some information about possible recoveries. Actual recoveries should be shown in the allowance account reconciliation proposed in the SD (see paragraph 9).

9. The staff believes that some of the user concerns can be addressed by adding more guidance to what is expected in the disclosure of the entity's write-off policy. The legal and regulatory environment in various jurisdictions may have an impact on whether enforcement action will continue and write-offs can, or will, be reversed. For example, in jurisdictions where tax relief is provided based on the write-offs recognised (as opposed to the balance sheet provision), an entity may write-off assets sooner and therefore have more reversals. **Therefore, because the level of enforcement activity can vary significantly the staff recommends that the disclosure of the entity's write-off policy should include discussion related to whether assets written off are still subject to enforcement activity. In addition the staff recommends that the**

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[1] This is because the write-off definition proposed in the original ED was 'A direct reduction of the carrying amount of a financial asset measured at amortised cost resulting from uncollectibility. A financial asset is considered uncollectible if the entity has no reasonable expectations of recovery and has ceased any further enforcement activities'.

nominal amount of assets written off, but for which the entity is still pursuing collection should be disclosed.

10. Users would find it helpful to understand whether write-offs are recognised sooner or later in the process, and to understand in turn whether reversals are typical or atypical. The staff believes that because the proposed disclosures in the SD propose a reconciliation of the allowance amounts, information related to recoveries will be included as part of that reconciliation providing users with information related to write-offs and recoveries/reversals.

11. The staff notes that IFRS 7, *Financial Instruments: Disclosures* also required a reconciliation of changes in the allowance account (when used) during the period for each class of financial assets. However, BC26 of IFRS 7 states that the Board decided not to specify the components of the reconciliation in order to provide entities flexibility in determining the most appropriate format for their needs. **The staff recommends that, in order to ensure that the amount of recoveries is included as a separate item in that reconciliation, the final standard require recoveries of previously written-off assets to be shown as a separate item in the reconciliation.** NOTE: Any decisions made on this topic are subject to any decisions made related to the definition of write-off in agenda paper 9.

Question 1 – Write-off policy
a. Does the Board agree with the staff recommendation in paragraph 9? If not, why and what would the Board like to do and why? b. Does the Board agree with the staff recommendation in paragraph 11? If not, why and what would the Board like to do and why?

Stress testing

12. In the original ED, the Board proposed that stress testing information be disclosed if an entity prepares such information for internal risk management purposes. Specifically, paragraph 20 of the original ED states:

> 20. If an entity prepares stress testing information for internal risk management purposes it shall disclose that fact and information that enables users of financial statements to understand:
>
> (a) the implications for the financial position and performance of the entity; and
>
> (b) the entity's ability to withstand the stress scenario or scenarios.

13. Further, paragraph B26 of the original ED states:

> B26. The information that an entity provides about stress testing would typically include (but is not limited to):
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> (a) how such stress tests are conducted;
>
> (b) a description of the stress scenario used and the related assumptions; and
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> (c) the outcome of the stress testing, including any significant conclusions.

14. The Board decided to require this information because they thought stress testing information would be useful and could enhance the sensitivity disclosures (providing a worst case scenario). However, not all entities perform stress testing for their financial assets held at amortised cost and, therefore, mandating stress testing was considered to be too onerous (at least for most non-financial services entities). Therefore, the original ED proposed that stress testing only be required *if* management performed such testing for internal risk management purposes.

15. Many respondents to the original ED expressed concerns with the proposed stress testing disclosure requirements. For example, CL148 states:

> We have doubts about the value of disclosing information about stress tests designed by management, because these differ across entities in terms of the issues on which they are focused, and the

> magnitudes of stress applied. Thus, they are not comparable across entities. Moreover, as drafted, the stress testing disclosures would relate to stress tests by an entity generally, and would not be restricted to those focused on credit risk of financial assets measured at amortised cost. Institutions should carefully consider how to provide disclosures about relevant information arising from stress tests, and their implications for the bank's estimates of expected credit losses.

16. Other respondents questioned the relevance of stress testing information to credit losses. In other words, there are many variables which are interdependent in a stress test and the ultimate effect on the credit performance of portfolios is difficult to ascertain. Further, stress testing may relate more to macro economic concerns than to credit losses. Some respondents state that stress testing may be more appropriate for reporting entities to discuss as part of management commentary, but not in the audited financial statements. Also, many responses discussing stress testing stated that this requirement would be better addressed by regulators, and not accounting standard setters.

17. Some respondents with large global operations stated that they have to prepare many stress tests for various regulators around the world. They were concerned that having to disclose that information would not only be extremely voluminous, but also commercially sensitive.

18. Comments received from users of the financial statements were generally supportive of including stress testing information. Responses to the user questionnaire indicated that stress testing (although favoured) would be the least used of the proposed disclosure requirements. Users did state, however, that stress testing would only be useful if it was required for all entities and standardised (so that all entities were applying the same stress scenarios).

Staff recommendation

19. The staff agrees with users that stress testing would be more useful if standardised and required for all entities. However, the staff also agrees with other constituents that stress testing may not be specifically relevant to credit losses. Furthermore, the staff does not believe that requiring all institutions (including non-financial institutions) to perform and disclose a standardised

stress test would provide sufficiently useful information to warrant the cost to preparers.

20. **Therefore, the staff recommends that the original proposed disclosures related to stress testing no longer be required in a final standard relating to impairment.**

Question 1 – Stress testing disclosure
Does the Board agree with the staff recommendation in paragraph 20? If not, why and what would the Board like to do and why?

Credit quality of financial assets

21. In the original ED, the Board proposed in paragraph 21:

> 21. For financial assets measured at amortised cost an entity shall disclose for each class of financial assets:
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> (a) a reconciliation of changes in non-performing financial assets during the period; and
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> (b) a qualitative analysis of the interaction between changes in non-performing financial assets and changes in the allowance account if that interaction is significant.

22. In paragraph B27 the Board described what the reconciliation needed to show, at a minimum as:

> (a) increases resulting from reclassification of performing loans as non-performing (ie deterioration of credit quality);
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> (b) increases resulting from acquisition of non-performing loans;
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> (c) decreases resulting from recoveries through enforcing securities;
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> (d) decreases resulting from recoveries due to payments of the debtor;
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> (e) renegotiations; and
>
> (f) write-offs.

23. The Board described their reasons for including this disclosure in paragraph BC61 as follows:

> Respondents to the Request for Information and others suggested that information about non-performing financial assets at amortised cost would be useful. This information about the credit quality of financial assets would provide transparency about their credit quality irrespective of the impairment approach used for financial reporting. The Board was informed that there has been increasing general acceptance of a 'more than 90 days' past due criterion and that using that criterion would promote comparability between entities. The Board found these arguments persuasive and decided to propose disclosures about non-performing financial assets and to define 'non-performing'. The Board noted that this proposal is consistent with the requests of many users of financial statements over a significant period of time.

24. The staff notes that feedback on these disclosures (both from users and other constituents) was generally positive. However, some respondents commented that recovery information was not always separated between those recovered through enforcing securities and those due to payments of the debtor.

25. The disclosure required, however, relied on the definition of 'non-performing' as 'the status of a financial asset that is more than 90 days past due or is considered uncollectible'. As mentioned above, the Board had been informed that this 90-day criterion had increasing general acceptance. However, through outreach and comments on the original ED, several respondents said that requiring a 90-day criterion would not be appropriate in all jurisdictions, or for all instruments. Therefore, they did not think the Board should define non-performing with a bright line of 90-days. In contrast, users liked the comparability that would result from providing a 90-day criterion in the definition.

26. The staff also notes that the information above is now largely included in the reconciliation of the allowance balance and the nominal amount of assets included in the 'bad book' (see paragraph Z7 of the SD). The differences in the new proposal and the old disclosure are that the decreases resulting from recoveries would no longer have to be split between those recovered through enforcing securities and those due to payments from debtor. In addition,

renegotiations, if staying in the 'bad book' are not specifically required to be disclosed in the new proposals. Renegotiations that cause an asset to move from the 'bad book' back to the 'good book' are a required disclosure in the current proposals.

Staff analysis and recommendation

27. The staff understands that defining a non-performing asset as an asset that is past due greater than 90 days creates a bright line, and may not be appropriate for all jurisdictions or asset classes. For example, some corporate loans may still be considered 'performing' even if 120 days past due when considering all relevant information. However, the staff believes that credit quality information related to assets that are not performing as initially expected is important. The staff also understands that comparability of this disclosure is important for users' analysis. By solely relying on the good/bad book criteria that will vary by entity there would be reduced comparability relative to the non-performing asset disclosure proposed in the SD.

28. The staff also notes that the proposals in the SD (using a 'good book' and 'bad book' differentiation) already require similar disclosure for the 'bad book'. It is anticipated that in many cases assets 90 days past due would be included in the 'bad book'. However, because the 'bad book' criterion does not include a 90-day bright line, not all such assets will be included. Therefore, in order to provide more comparability for users, **staff recommends that a similar disclosure to that required in paragraph 21(a) and B27 of the original ED be required <u>for assets that are 90 days past due, but not included in the 'bad book'</u>. For example, the following would be required, at a minimum,** in the reconciliation of changes in the nominal amount of financial assets 90 days past due not included in the 'bad book':

    (a) increases resulting from loans becoming greater than 90 days past due during the period (ie deterioration of credit quality);

    (b) increases resulting from acquisition of loans already greater than 90 days past due;

(c) decreases resulting from recoveries of assets that were greater than 90 days past due, but not included in the 'bad book';

(d) renegotiations; and

(e) write-offs.

This decision would clearly need to be reassessed if the good/bad book distinction or the associated disclosures are not finalised as proposed in the SD.

29. If this disclosure were required, in addition to the currently proposed 'bad book' nominal and allowance amount reconciliations, then the original ED definition of 'non-performing' is no longer necessary. **Therefore, the staff recommends deleting the definition of 'non-performing'.**

Question 3 – Credit quality of assets
Does the Board agree with the staff recommendation in paragraphs 28 and 29? If not, why and what would the Board like to do and why?

Origination and maturity (vintage) information

30. In the original ED, the Board proposed that information showing the year of origination and the year of maturity (vintage information) should be disclosed (see paragraph 22 of the original ED). Paragraph B29 of the original ED required that the information be disclosed in a tabular format on the basis of nominal amounts.

31. In the Basis for Conclusions to the original ED (see paragraph BC62), the Board noted that it had been informed that the vintage information disclosure would provide useful information because:

(a) it allows users to assess credit risk that is associated with particular vintages; and

(b) it facilitates the analysis of the quality of the lending business that users of financial statements perform.

32. Paragraph BC64 goes on to explain that:

> The Board decided to propose requiring the information to be disclosed as nominal amounts because the nominal basis is more useful for the purpose of the analysis of the quality of the lending business. The Board also considered that using the carrying amount might create significant practicability issues regarding impairment assessments performed on a portfolio level if the portfolio includes assets from different vintages.

33. The staff also notes that the original ED proposed credit loss triangle information be disclosed to show the comparison between the development of the credit loss allowance over time and cumulative write-offs. This disclosure would have required entities to disclose by year of origination the build up of the credit loss provision and the cumulative write-offs. When used in conjunction with the origination and maturity table, users would have been able to assess credit risk associated with particular vintages and analyse the quality of the lending business. However, the SD proposes that the loss triangle disclosure be replaced with a comparison of previous estimates of expected credit losses with actual outcomes (ie backtesting). That disclosure is not required by vintage as many entities use open portfolios and calculate expected losses and assess actual outcomes at the portfolio level (which likely includes many vintages).

34. Many respondents (other than users) to the original ED commented that vintage information would be costly to provide (especially for open portfolios) and, in their opinion, would not be useful for all financial assets. Such respondents also commented that the information to be provided would be extremely voluminous, especially for longer dated instruments, and for entities with multiple portfolios or asset classes. It appeared that many preparers believed vintage information was being provided in order to help users understand how expected loss estimates were derived. From the preparers' perspective, vintage information is not a significant factor in calculating expected loss estimates especially in an open portfolio setting. This is because multiple vintages are placed into a single

portfolio based on credit ratings, for example, and expected losses are calculated on that basis (not generally considering vintage information).

35. However, the staff note that providing the vintage information was not for the purpose of helping users recalculate expected loss estimates. Rather, it was to help users understand the origination activity by vintage because the quality of underwriting can vary over time.

36. A few respondents (other than users) who stated that the proposed disclosure was not useful indicated that using the nominal amount in the disclosure fails to reflect the extent to which a provision has been made or losses have occurred. These respondents suggested that the disclosure would be more useful if the provision or losses by vintage was included in the disclosure. This might be done by showing the default rate per origination date, perhaps in a graph form, as opposed to tabular form (see Appendix A for an example). However, gathering this information may be costly and difficult for some institutions (especially non-financial institutions). Furthermore, the staff does not believe that linking the provision or write-offs to the vintage in an open portfolio would always be possible.

37. Some of those respondents also stated that the disclosure is only relevant for certain types of assets where vintage can be linked to the credit risk profile (for example residential mortgage loans). They did not believe that vintage information is useful for all types of financial assets, such as highly rated debt securities, some securitised instruments, revolving credit facilities, short-term trade receivables or credit card receivables. For example, it may not be relevant for a securitised debt instrument with numerous underliers with different vintages.

38. On the other hand, users were in support of the proposed disclosure, and responded that vintage information is useful in their analysis to help assess the credit quality of particular vintages and whether lending standards have relaxed. User feedback was not specific about the aspects of the disclosure they liked.

While a few users suggested enhancements to the disclosure, most users indicated that the proposed disclosure would be sufficient for their analysis.

39. With maturity by vintage, users could understand how long financial assets of different vintages were expected to be outstanding. A few users noted that they would like the disclosure to show changes in credit conditions over time, which we believe would necessitate showing provisions or write-offs by vintage, and was also one of the reasons for including the credit loss triangle in the original ED. However, as previously mentioned, the credit loss triangle was deemed too operationally difficult to provide and was replaced with the comparison of expected losses to actual outcomes in the SD.

40. A few respondents asked for clarification about the terms 'maturity' and 'origination'. They questioned whether maturity referred to the expected maturity (considering prepayments) or the contractual maturity. They also questioned whether origination referred to the date of the initial contract or the date the terms of the contract were renegotiated, if applicable.

Staff analysis and question for the Board

41. When the Board proposed the vintage information disclosure in the original ED, it did so with the intent of helping users assess credit risk and the quality of the lending business for an entity. However, staff believes that the disclosure as currently drafted is only useful in that context when used in conjunction with the credit loss triangle, or by also disclosing the write-offs or provisions related to each vintage. Staff also notes the consistent feedback that this information would be costly for preparers to provide. In some cases, the information would be virtually impossible to generate, like in an open portfolio where provisions are not assigned to a specific asset (for example, provisions in the 'good book'), and therefore not to a specific vintage. However, staff does believe that the information could be relevant to users when it is possible to provide (for example, provisions in the 'bad book'). Staff believes that an objective and principle should be outlined for this disclosure, and entities should provide the disclosure when relevant.

42. However, the staff notes that some respondents commented negatively on the proposal that stress testing only be required if an entity uses it for their internal purposes saying that stress testing should be required for in all cases or in no cases. The staff recognise that some constituents may feel similarly with a proposal that would require disclosures about vintage based on an objective (and therefore, not necessarily for all preparers or all assets measured at amortised cost). But the staff have been swayed by the operational concerns of preparers related to information currently available for open portfolios. Requiring this disclosure (with credit losses) for all entities seems to contradict the Board's previous decisions to allow operational simplifications to the impairment model.

43. Therefore, the staff believes that there are three possible approaches the Board could take to address user concerns and the feedback from other constituents:

    (a) Approach 1 – delete the vintage information requirement;

    (b) Approach 2 – require vintage information as proposed in the original ED; or

    (c) Approach 3 –try to confine vintage information to particular scenarios.

Approach 1 - Delete

44. The Board could delete the requirement to provide vintage information. The Board decided not to proceed with the loss triangle disclosures because comments were received that the necessary information did not exist for all types of instruments by vintage. Or, if it did exist, it would be extremely costly to provide. The staff notes that the vintage disclosure was designed to be used in conjunction with the loss triangle information. Therefore, the Board could similarly decide not to include the vintage information in the final standard. Not including it would also alleviate concerns of some constituents that disclosures should be either required in all cases or in no cases.

45. However, users would not be presented with information to help them assess the credit risk associated with particular vintages.

Approach 2 – retain requirement

46. The Board could always require the disclosure as proposed in the original ED (with clarifications for 'maturity' and 'origination'). However, the staff believes that the vintage information is less useful because the loss triangle is no longer required. In addition, the staff also believes that requiring the disclosures for all instruments and all institutions seems to contradict the Board's previous decisions to permit operational simplifications for impairment accounting.

47. However, requiring the information would give users vintage information.

Approach 3 – modify the requirement

48. The Board could try to revise the requirements in the original ED so that the disclosure would include additional information about write-offs or provisions but the vintage information would only be required in scenarios in which it would be most useful for users. The staff notes that it may be difficult to articulate an appropriate objective and principle for when such disclosure would be required and for which types of assets (which the staff believes would be necessary in order to provide meaningful information). This would address user demand- but the staff note that the proposal to propose stress testing only in some circumstances in the original ED was not popular.

49. The staff believes that information related to write-offs and provisions for particular vintage years should be available for financial assets where such information is relevant as it is a useful risk management tool. Also the staff and some Board members have been made aware of the information existing for certain types of financial assets (eg residential mortgages in certain jurisdictions). The staff think one appropriate approach may be to require the information for relevant vintages (for example, when either the nominal amount of assets originated in a year or the amount of provisions or write-offs taken against a year are high compared with averages for the entity). An entity would then disclose the nominal amounts by origination year and the write-offs or provisions related to relevant vintage years.

50. If Approach 3 is the preferred approach, the staff will work further to determine how best to define and clarify when vintage information needs to be disclosed.

Question 4 – Origination and maturity (vintage) information
The staff is requesting the Board provide direction for which approach to undertake. Does the Board prefer Approach 1 (deleting vintage information requirement), 2 (maintaining vintage information requirement), or 3 (modifying vintage information requirement)? Why? Or, if none of those approaches, what would the Board like to do and why?

51. If the Board wants to pursue either approach 2 or 3 (ie require vintage information in at least some circumstances) the following analysis is relevant to that information.

52. The staff does not believe that vintage information would be relevant for short-term receivables or revolving credit facilities (eg credit cards) because of the short-term nature and the revolving nature. The short term nature means that the information would be provided after or close to when the receivables mature or are written off. The revolving nature means that it is hard to identify into which vintage year the amounts should go, and whether credit losses are concentrated to a particular origination year. **Therefore, the staff recommends that short-term receivables and revolving credit facilities should be excluded from any vintage information disclosure requirement.**

53. The staff believes that maturity information (based on contractual maturity) should be disclosed if vintage information is provided. Therefore, **the staff recommends that contractual maturity would be disclosed** because the focus is on credit exposure and if problems occur prepayments are less likely. Contractual maturity would provide users with an indication of how long these assets could remain outstanding.

54. The staff believes that the origination date for vintage information should be the date of the original contract. Therefore, **the staff recommends that the date of the initial terms of the contract is the origination date and disclosed** because

the staff believes that date is more relevant for this type of disclosure, rather than updating it each time a contract is renegotiated[2].

55. **The staff recommends that the format of the disclosure not be mandated**.

Question 5 – Questions if approach 2 or 3 is selected
If the Board chose either approach 2 or 3, does the Board agree with the staff recommendations in paragraphs 52-55 (to exclude short-term receivables and revolving credit facilities, clarify 'maturity' and 'origination', and to not mandate a format for the disclosure)? Why? If not, why? And, what would the Board like to do and why?

[2] Assuming that the loan was not derecognised as a result of the renegotiations. If a loan were derecognised then the date of recognising the renegotiated loan would be the origination date for these purposes.

Appendix

A1. The following graph represents an example of a possible vintage disclosure including origination dates and provisions or write-offs. This is only an example of a possible graphical format. The staff notes that if the Board decides to revise the currently proposed disclosures, then further thought would be required into the actual format and amounts required. If this method is used, the maturity information would be disclosed separately.