



Project

Financial instruments: Impairment

Topic

Transfer between buckets

Purpose of this paper

1. At the June 2011 meeting the boards decided to continue to develop a ‘three-bucket’ expected loss approach for the impairment of financial assets. The guiding principle of the ‘three-bucket’ approach is to reflect the general pattern of the deterioration of credit quality of loans. The different phases of the deterioration in credit quality are captured through the ‘three buckets’ that determine the allowance balance for all financial assets subject to impairment accounting. At the June meeting, the boards noted the importance of having clear and well-defined criteria to determine when to allocate assets to and transfer assets between Buckets 1, 2, and 3. Therefore, they instructed the staff to further develop these criteria.
2. This paper outlines possible approaches to determine how assets are allocated to each bucket and when assets are transferred between Buckets 1, 2, and 3. The paper outlines considerations for the alternative approaches and requests direction from the boards regarding the approach to be further developed.
3. IASB agenda paper 7B / FASB memorandum 101 considers the appropriate allowance balance for Bucket 1. The staff note that there is an interaction between these papers in the sense that if the boards are concerned with the overall adequacy of allowance balances, the broader Bucket 2 is (ie the quicker loans of deteriorating credit quality are transferred to Bucket 2) arguably the lower the allowance balance that needs to be established for Bucket 1.

Background

4. At the June meeting the boards agreed to pursue an impairment model that would allocate financial assets subject to impairment accounting (to be referred to in this paper simplistically as ‘loans’) between three categories or buckets. The allocation discussed at the June meeting was as follows:
 - (a) **Bucket 1** – In the context of open portfolios, this bucket is comprised of loans that are evaluated collectively that do not meet the criteria for Buckets 2 or 3. This essentially would consist of assets that have NOT been affected by observable events which indicate a direct relationship to possible future defaults although they may have suffered changes in credit loss expectations as a result of macroeconomic events that are not particular to a (group of) loan(s). Therefore, the allowance amount would be less than the losses expected to occur over the life of the loans. The amount of the allowance balance for this category is further discussed in IASB agenda paper 7B / FASB memorandum 101.
 - (b) **Bucket 2** – This category consists of assets that have been affected by the occurrence of observable events or conditions that indicate a direct relationship to possible future defaults, however the specific assets in danger of default have not yet been identified. A default does not have to occur for assets to be subject to the impairment requirements in Bucket 2. However, there must be an observable event that relates to the assets that indicates potential impairment. An allowance amount equal to the full remaining expected lifetime losses is recognised for the assets in Bucket 2. Because the assets within Bucket 2 are not loans where expected credit losses can be specifically identified, the loss calculation would be performed at a portfolio level as opposed to on an individual basis.
 - (c) **Bucket 3** – This category consists of loans where information is available that specifically identifies that credit losses are expected to, or have, occurred on individual assets. No default need have occurred for loans to become part of Bucket 3. The allowance balance is the full remaining lifetime expected losses for these loans.

5. The boards agreed to pursue this approach to impairment accounting and asked the staff to further develop the criteria for the three buckets. In particular it was suggested at the meeting that an approach based on the current impairment triggers used for IFRS and US GAAP (an event-based approach) and an approach based on credit risk management be investigated. Note that depending on the final approach chosen, the description of what is included in each bucket may change from what was discussed in the June meeting (ie paragraph 4(a)-(c) above)
6. Staff would also like to note that describing the approach via three buckets is helpful at this point in developing the overall direction but that ultimately we need to consider whether three buckets are necessary given that the allowance balances for both Buckets 2 and 3 are based on remaining lifetime expected losses. It may be simpler just to ensure that an allowance balance equal to remaining lifetime expected losses is established at a point in time sooner than when today's incurred loss model begins to apply by clearly defining a principle for transferring loans out of Bucket 1.
7. Furthermore, it is also noted that a two-bucket approach might also work better for consumer loans. From our preliminary outreach activity, it is our understanding that those loans are monitored on a delinquency notion which may be more consistent with a transfer directly from Bucket 1 to Bucket 3. The credit risk management approach in this paper currently focuses very much on notions used for commercial or wholesale loans. Therefore, the staff will need to investigate the overall application of a final approach to consumer loans.
8. In addition, the boards tentatively decided at the March 2011 meeting that loans that are acquired at a discount due to credit losses that would be recognised in the 'bad book' would have the EIR calculated taking into account initial credit loss expectations and that no allowance should be established on initial recognition. This is different to accounting proposed for all other loans. As a result, once a basic model is established for all other loans the appropriate bucket allocation for these loans acquired at a discount due to credit losses should be discussed.
9. The approaches investigated by the staff are outlined below:

- (a) Approach 1: Event-based approach
 - (b) Approach 2: Credit risk management approaches
10. In considering the approaches we sought initial input from some of our constituents that has been factored into the models. Feedback we have obtained through that process is included in the analysis below.

Approach 1: Event-based approach

11. This approach would apply the three-bucket model and would require that all loans start out in Bucket 1. Transfers of loans across buckets would occur based on an assessment of specific events that indicate the existence of credit deterioration or improvement. Using an event-based approach to determine when loans are transferred between categories means it is necessary to differentiate (a) events and changes in conditions that would trigger the transfer of a loan between buckets from (b) events and changes in conditions that would not trigger such a move but would instead result in a change in the loss expectations for a specific bucket. For example, at the June 2011 meeting a distinction was made between macroeconomic events that would affect numerous portfolios that would result in an adjustment to the loss expectations used in Bucket 1 and an event specific to a particular portfolio that would cause that portfolio to be transferred to Bucket 2.
12. Under this type of approach, a principle would need to be established to differentiate the types of events and changes in circumstances that would cause transfers from those that would not. The staff considered four possible ways to implement this type of approach, as follows:
- (a) Specify that all changes in macroeconomic factors would affect the losses recognised for loans in Bucket 1 but other events would be considered in determining whether a loan would move to Bucket 2.
 - (i) The staff believe this type of approach does not achieve the boards' overriding objective of reflecting a loan's credit migration. If all macroeconomic factors result in Bucket 1 loans staying in that category irrespective of the potential impact on overall credit quality, this would

not be in line with the general principle of reflecting the deterioration in credit quality in the allowance in all circumstances. Determining whether loans are transferred across the various buckets based on specified events is also somewhat artificial as it is not necessarily in line with an increase or decrease in credit quality.

- (ii) Based on initial outreach to date, the staff understands that banks' credit analysis is a multi-factor analysis. It does not focus on whether a particular type of event has caused a change in credit loss expectations. From our outreach activity with some EAP members, we understand that transfers simply based on particular types of indicator events (ie a particular set of information) would not be in line with credit analysis. In fact, credit quality is affected by all relevant information/events that drive credit risk which includes firm specific or idiosyncratic measures as well as broader macro factors. Thus, credit analysis is a multi-factor analysis and transfers between the buckets ideally should not be based on particular types of events. To illustrate this, consider the example about the mortgage loans in the June board paper¹. One might observe a rent decrease in buy-to-let loans in Town ABC but depending on other factors, this event might not result in an increase in credit risk even though the event itself is observable and has a direct relationship to possible future defaults. The event might not result in higher credit risk because other factors counter it (eg the borrowing is fully collateralised and thereby there is no increase in the risk of default).

- (b) Specify that events have an indirect effect on credit losses would result in a change in credit loss expectations for loans classified in Bucket 1 while event or changes in circumstances that have a direct relationship/correlation with a potential future default would require a transfer to Bucket 2.

¹ See paragraphs 11-13 of IASB agenda paper 8 / FASB memorandum 99 of the June 2011 meeting.

- (i) The staff believe distinguishing between those events that have an indirect effect versus a direct effect on a future credit loss is not practicable because the relationship of the event to the likelihood of a loss may not be discernible. Also, this distinction may not necessarily result in events with the most detrimental effects on expected losses causing transfers. Furthermore, it would not reflect the nature of credit risk assessment which is holistic as noted above.
- (c) Specify that an entity evaluate whether an event is such that it would change the price that an entity would now offer on a loan or would affect whether it would offer a particular product. This would help prevent events that have little impact on credit risk from causing a transfer of loans.
 - (i) The staff believe this approach ties the event more closely with an actual consequence that indicates an effect on credit. However, it raises implementation questions about how significant the effect needs to be (eg situations in which pricing only moves by an insignificant amount) and would likely not be practicable because it also requires a link between the event and the effect to be established. It is not always possible to isolate if a change in price or the change in product occurred because of credit deterioration. Pricing changes and product offerings are also a function of factors such as demand and liquidity. But even if it was possible to isolate it, the change is a RESULT of the credit deterioration. Depending on how quickly entities adjust their products or prices due to the decreased credit quality, there is a risk that loans move into Bucket 2 too late. As a result, while a change in price or product may serve as a further indicator, the staff believe that a transfer to Bucket 2 cannot be too closely restricted to this.
- (d) Specify that the severity of the potential impact of the types of information (eg events) would determine whether it should result in a transfer between buckets.

- (i) The staff believe that this approach would not necessarily distinguish events in a manner consistent with the examples discussed at the June meeting (for example, a very large change in GDP in Country X may well have a significant effect on loss expectations but it is not specific to a portfolio).
- 13. Overall, the staff struggled to identify a principle to differentiate events and changes in circumstances that would require a transfer across categories from those that would not. The staff are also concerned about the practical difficulties of an approach for classification of loans in the three buckets and transfers across buckets based on specific events and changes in expectations. The staff believe this approach is open to significant interpretation and inconsistent application. The staff are also concerned that a model that requires events to be identified can act as a barrier to the recognition of impairment losses as is apparent in the incurred loss model today.

Approach 2: Credit risk management approaches

- 14. The staff have considered two alternative approaches that utilise aspects of credit risk management:
 - (a) Approach 2A: An ‘absolute credit risk model’ whereby the buckets would align with the credit quality of loans;
 - (b) Approach 2B: A ‘relative credit risk model’ whereby the buckets would be determined based on whether credit quality has deteriorated (or improved).
- 15. As noted in paragraph 7, it is the staff’s understanding that consumer loans typically follow a notion of delinquency, as opposed to a true credit deterioration, and therefore any final model based on one of the following approaches will need to be further investigated for applicability to consumer loans.

Approach 2A: Absolute credit risk model

16. Under this approach the objective is to reflect the change in credit quality of loans *consistent* with an entity's credit risk management practices. Credit quality is usually measured in terms of probability of default (PD), loss given default and exposure at default. Credit risk management systems differentiate between financial assets on the basis of their absolute credit quality at the date of evaluation. By following credit risk management practices, the three buckets would capture the different levels of credit risk in absolute terms. Assets would be categorised by a specific level or range of absolute credit risk, with Bucket 1 having the lowest level and Bucket 3 having the highest level of credit risk in absolute terms. As a loan is originated or purchased it would be classified in one of the three buckets in accordance with its absolute level of credit risk, regardless of whether the pricing of the loan reflects the inherent credit risk upon origination or purchase. Depending on the magnitude of change in the absolute level of credit risk, loans then migrate downward or upward into another bucket that is defined in line with the 'new' level of credit risk.
17. The staff envisions that this approach would be implemented by entities 'mapping' their existing credit rating categories to the three buckets. This could be done by establishing the credit risk characteristics of the loans that would fall within each of the three buckets in the impairment model. Entities would then be required to map their internal risk rating categories to the three buckets based on the characteristics of their categories. Enough guidance would be needed so that entities that use credit risk rating systems with more or less than three categories could map their existing categories to these buckets on the basis of the primary characteristics of the categories. Also, even if an entity had only three categories, they may not necessarily align with how the guidance might differentiate the three buckets for impairment recognition purposes. It is also noted that some less sophisticated entities or entities in some industries (for example corporates) may not have such credit risk systems in place at all. However, the characteristics established for the buckets will still be used to guide the classification of loans within the three buckets for these entities.
18. The staff observes the following regarding this approach:

- (a) Using entities' credit risk grading systems would align accounting and credit risk management.
- (b) It does not raise the tracking issue (discussed below) that the relative credit risk model introduces so operationally it is expected to be less complex.
- (c) Loans would be classified in accordance with their absolute level of credit risk. In other words, loans of like credit quality whether or not newly recognised would be classified in like buckets.
- (d) If loans are originated or purchased with high credit risk (eg loans below investment grade or on a watchlist) these loans are allocated to high risk rating categories in credit risk management systems. Therefore, if credit risk rating systems were used as a basis for determining the impairment accounting buckets, some loans that are newly originated or purchased (such as micro loans or leveraged finance loans) would be classified into Bucket 2 due to their level of credit risk and lifetime expected credit losses would be recognised in the first reporting period.
- (e) Some staff believe that, conceptually, credit impairment losses should not be recognised immediately on a newly originated or purchased loan because, assuming those loans are priced at market, it would result in a better alignment of the credit risk embedded in the pricing of the instrument. Therefore, those staff believe that an event such as a deterioration in credit needs to occur before recognising the losses expected in original pricing.
- (f) As mentioned above, reporting entities may have credit risk systems with considerably more than three categories and they would need to map their existing categories to the three buckets on the basis of the primary characteristics of their categories. As a result, some are concerned there could be significant judgment as to how internal rating categories should be mapped to the impairment buckets for accounting purposes. This would result in a lack of comparability between entities. While the lack in comparability could be overcome by

defining the three buckets using a scale from 0-100% for PDs, that would create bright lines. This would mean that an arbitrary distinction between PDs would determine which buckets assets fall into, which has a profound effect on allowance balances. The staff learned during outreach activities that the rating scales and thus the level of PDs allocated to each category may vary by asset class.

19. As a result, the principles for transfers to Bucket 2 and 3 could be defined as follows:

(a) Loans are required to migrate from Bucket 1 into Bucket 2 if evidence supports:

- (i) a deterioration in financial performance of the borrower that results in an absolute change in credit risk from low to medium/high, together with**
- (ii) an increase in uncertainty about the ability to fully recover cash flows**

(b) Migrating loans from Bucket 2 into Bucket 3 is required if evidence supports

- (i) a deterioration of financial performance of the borrower that results in an absolute change in credit risk from medium/high to high/very high together with**
- (ii) expected non-recoverability of cash flows**

20. Please note that these definitions are suggested to provide a general direction and we would conduct further outreach to ensure those principles are operational.

Approach 2B: Relative credit risk model

21. The overall objective of this approach is to reflect the credit deterioration or improvement in loans making maximum use of credit risk management practices.

22. This approach is a hybrid approach that seeks to resolve concerns about the other approaches outlined in the memo, as follows:
- (a) It does not require particular types of events to be identified as a basis for transfer;
 - (b) It considers the concept that the expectation of credit losses priced into the loan would not be reflected in the financial statements until deterioration starts to occur, which some believe results in a better alignment of the credit risk embedded in the pricing of the instrument;
 - (c) It incorporates some credit risk management practices; and
 - (d) Instead of the absolute level of credit risk, it is based on *changes* in credit risk.
23. This approach would result in the movement of loans between buckets depending on changes in credit loss expectations. Under this approach, all originated and purchased loans would initially start in Bucket 1 (because the loss expectations are embedded in the pricing, some consider it inappropriate to recognise remaining lifetime expected losses in the first period²). This means that loans of varying credit quality would be recognised in Bucket 1 (because loans of varying credit quality are originated and purchased). However the credit loss expectations used to determine the allowance balance for Bucket 1 would reflect the varying credit quality within that category. This means that when high risk loans are newly originated the expected losses used to determine the bucket 1 allowance balance would be higher.
24. Given loans with varying credit quality would be recognised in Bucket 1 and a transfer to Bucket 2 is based on a change in credit loss expectation, there may in fact be some loans with a higher credit risk in Bucket 1 than some other loans in Bucket 2. For example, consider a loan that is originated on market terms to a low quality obligor (high credit risk) and a loan that is originated on market

² It is noted that purchases of loans acquired at a discount due to credit losses are outside the scope of this paper due to the boards' earlier decision to adjust the effective interest rate for those loans to reflect the initial credit loss expectations. Because the effective interest rate is calculated differently than for all other financial assets subject to impairment accounting, those loans will be considered separately. As a result, it is assumed that all loans considered in this paper are performing at the time of origination or purchase when considered on an individual basis.

terms to a high quality obligor (low credit risk). Upon origination both loans would be classified in Bucket 1. If the loan to the high quality obligor deteriorates in credit risk, the loan would be transferred from Bucket 1 to Bucket 2 even though it might still have an absolute level of credit quality that is higher than the loan that remained in Bucket 1.

'Watchlist' notion

25. One way to capture the concept of credit deterioration (and improvements) would be to use a 'watchlist' notion. Credit risk management today across jurisdictions incorporates a notion of a 'watchlist' (at least for wholesale portfolios). For a 'watchlist', management is typically monitoring the loan more closely than its general loan book. Based on discussions to date, the staff understands that loans are transferred onto a 'watchlist' if there is an indication of increased credit risk. In addition from those discussions, it seems that the 'watchlist' notion is forward looking and very responsive to changes in information that affects credit loss expectations. It seems consistent with the type of situations the boards discussed where they considered that a transfer to Bucket 2 would be appropriate but has the benefit of not requiring that particular types of events be identified as a basis for transfer.
26. If we capture the notion of 'heightened credit risk' well, it should result in a model that transfers loans to Bucket 2 and establishes allowances based on remaining lifetime loss expectations when credit problems first arise.
27. Based on the description of 'watchlist' practices to date, loans on 'watchlists' are not necessarily of like credit quality. In other words, the 'watchlist' does not necessarily map to a specific set of internal rating grades (eg say grades 4 through 6). The focus is rather on actual or anticipated deterioration in credit quality. For example, a loan to a high quality obligor that deteriorates may be considered to have 'heightened credit risk' because its credit risk has increased although it may be classified as a good quality loan (eg grade 3). The absolute credit quality of that loan may still be higher than that of other loans on the 'watchlist' and may in fact be higher than some loans that are not on the 'watchlist' at all and considered to still be fully performing. However, this is

consistent with the notion that the model is attempting to capture the deterioration in credit quality rather than absolute credit risk.

28. The staff notes that the concept of a watchlist is incorporated into some banks' risk grading systems. Therefore, this notion of 'watchlists' also could be used within the Absolute Credit Risk Model in these cases (Approach 2A).
29. It is however noted that some believe that it is appropriate to establish like allowance balances for assets of like credit quality and that therefore all like rated assets of like credit quality should be in the same bucket³. Some of the preparers we have spoken to hold this view of an absolute credit risk approach where all like rated assets would be in the same bucket as opposed to focusing more on the credit deterioration from origination/purchase.
30. While it is not typical, we understand that some entities in some jurisdictions do originate or purchase loans directly onto their 'watchlists'. Under Approach 2B, assuming those loans are purchased or originated on market terms for the reasons set out above some staff believe that while these loans would be on the entity's 'watchlist' for credit risk management purposes they initially be included in Bucket 1 for impairment accounting purposes. The allowance calculation in Bucket 1 would reflect their (higher) expected losses. However, because the pricing incorporates expected credit losses, recognising a full lifetime expected loss on day one (which would result if putting these loans immediately into Bucket 2) seems counterintuitive for some staff.

Operationalising a 'watchlist' approach

31. It is suggested that the underlying principle of when loans are put on a 'watchlist' (or once the principle of a 'watchlist' regarding the concept of heightened credit risk is satisfied) could serve as one of the indicators of when loans are *transferred* to Bucket 2. This would have the benefit of allowing entities with credit risk management systems that include the notion of a 'watchlist' that is consistent with our principles to utilise their credit risk management systems as part of their impairment accounting. While entities don't currently differentiate between loans on the watchlist that were

³ The absolute credit risk approach described above would have this result.

originated/purchased directly onto the watchlist and those transferred to the watchlist, based on our discussions with some preparers it seems that starting to track this should be operationally feasible.

32. To implement this approach, the staff envision developing a clear and well-defined principle about when loans are placed on a ‘watchlist’ which should result in a transfer for impairment accounting purposes. The principle ideally should work for all types of loans (ie both consumer and commercial loans). The staff is not proposing that we simply say that the transfer to an entity’s ‘watchlist’ as the criteria for loans being transferred to Bucket 2 as ‘watchlist’ practices may vary between constituents and across jurisdictions, differ across portfolios, are not typical for consumer products and may not be present in corporates or insurers. Rather, if this approach is pursued, we would work on developing a principle that incorporates common notions of what a ‘watchlist’ is (for example focussing on the concept of heightened credit risk which may include considering how various events affect the pricing or the appetite for offering a product in the current environment).
33. As a starting point for developing a principle to describe the watchlist, the staff looked at the feedback received on the definition of a ‘watchlist’ in the disclosures proposed in the IASB-only Appendix of the SD and on the good/bad book split of the SD.

Watchlist definition and disclosures

34. In the IASB-only Appendix, the definition of the term ‘watchlist’ was as follows:
- Watchlist:** A list that comprises financial assets or debtors for which information has indicated increased uncertainty about the financial asset’s collectability to such a degree that the entity considers the asset needs to be monitored more closely.
35. We received very limited feedback on the proposed definition of a watchlist and its related disclosures. Constituents rather focused on the disclosures in general. However, the feedback we received confirmed that it is necessary to establish a clear and well defined principle as to when loans are migrated and that referring to a transfer on the watchlist is not sufficient to improve consistency and comparability among entities.

36. Constituents were concerned as institutions have a very diverse view about definitions of a watchlist and practices also vary across portfolios and industries. In many cases no objective criteria exist for the watchlist notion. (SD CLs 65, 153, 190, and 64). For example, respondents from Australia noted that the use of watchlists amongst their big four banks can range from reasonably well rated entities that are under close review to entities rated a lower grade, but not yet considered 'troublesome' to pure 'troublesome' loans. This might lead to a lack of comparability if one were to rely on the watchlist principle without further articulation (SD CLs 59, 65, 174, 21, 124, and 64).
37. Some constituents noted that banks might consider a classification of loans in the 'watchlist' as evidence for non-performance and an indicator for moving such a loan into the bad book per the SD (SD CL 100).
38. In respect to the watchlist disclosure, constituents were concerned that it would lack comparability (SD CLs 65 and 21).
39. The staff think that the concept of 'heightened' credit risk which underlies watchlists as they have been described to us by the constituents we have spoken to would be a helpful means of identifying loans that should be transferred. However, the above indicates that if a watchlist concept is to be fundamental to transfers the principle would need to be developed beyond the definition exposed in the SD.
40. Staff also considered the feedback from the good book/bad book split to see if it would assist in developing a principle for transferring loans between different categories. Most of the feedback was not relevant to the current discussion as it focussed more on identifying absolute problem loans rather than those whose credit quality was beginning to deteriorate.
41. Many respondents to the SD felt that focusing on changes in the expectations of collectability of cash flows was a more robust way of determining when good/bad book transfers should occur. This may also help in determining when credit quality is deteriorating for the purpose of causing transfers between buckets.

Credit risk management migration approach

42. A similar approach would be to use movements within the credit risk management categories as these categories are based on credit risk and expectations of recoverability of cash flows (eg through PDs etc). Thus, instead focusing on a watchlist, the principle would focus on movements across rating categories.
43. A difficulty with using transfers between credit risk categories is the variation in categories used between entities. This means that focussing in isolation on whether there has been a transfer between categories for internal credit risk management purposes may not be an appropriate basis for determining whether there should be a transfer between buckets for impairment accounting purposes. It also raises issues with comparability. However, transfers of financial assets between buckets could be based upon several indicators, for example capitalising on the Basel capital framework and related risk management processes (eg reviewing some regulatory guidance as a starting point for developing indicators). This could involve for example changes in expectations regarding recoverability of cash flows and drawing on the borrowers' status as performing, non-performing or defaulted, and their deterioration within an internal credit risk grading system.
44. Using this approach, the principles would not make explicit reference to any type of watchlist concept even though they contain aspects of those concepts (ie to the extent a watchlist does have a clear link to changes in credit risk and expected recovery of cash flows one could argue the principles do reflect a watchlist approach).
45. As a result, the principles for transfers to Bucket 2 and 3 could be defined as follows:
- (a) **Loans are required to migrate from Bucket 1 into Bucket 2 if evidence supports:**
- (i) **a deterioration in financial performance of the borrower which leads to**
 - (ii) **an increase in uncertainty about the ability to fully recover cash flows**

(b) Migrating loans from Bucket 2 into Bucket 3 is required if evidence supports

- (i) a further deterioration of financial performance of the borrower together with**
- (ii) expected non-recoverability of cash flows**

Note that Bucket 3 includes individually identified defaulted loans.

46. Please note that these definitions are suggested to provide a general direction and we would conduct further outreach to ensure those principles are operational.

Other issues

Portfolio segmentation

47. Current US GAAP and IFRSs do not provide specific requirements for portfolio segmentation for applying impairment guidance. In the US, this type of guidance primarily resides in the regulatory reporting framework. The staff believes that under any approach selected, guidance should be provided on the level of portfolio segmentation that would be necessary to implement that approach. The level of portfolio segmentation is important because it affects the level at which the guidance is applied. Changes in loss expectations and therefore credit impairment losses for a specific bucket will be the result of evaluation of numerous portfolios that fall within that bucket. If entities are required to segment on a fairly granular level, then the evaluation of credit losses for portfolios should produce results that are potentially more reflective of differences in credit risk based on loan characteristics and potentially more reactive to changes in relevant factors that result in actual losses.

Application to debt securities

48. The staff need to investigate whether the approach being discussed is applicable to debt securities. For example, the staff needs to gain an understanding of the current processes in place for management of credit risk of debt investment

securities, including whether such management occurs on a portfolio or individual asset basis, whether credit risk grading or watchlist concepts are applicable to securities, etc.

Individually significant loans

49. The staff need to address whether the approaches being discussed are also applicable to individually significant loans (ie, loans that are unique or significant in size for the lender that are monitored on an individual basis) as credit risk management systems may be applied in a different way for those loans.

Disclosures

50. It is too early to discuss detailed disclosures to go with the impairment model. However, it is noted that basing the model on credit risk management introduces the risk of non-comparability. This can be reduced by establishing a principle for Buckets 2 and 3, but in addition, it would be necessary to supplement that with disclosure of the indicators used by entities for moving to Buckets 2 and 3. For examples, as there are potential differences in the way of determining whether contractual cash flows will NOT be recovered in full based on, for example, credit risk management practices, market sectors, national jurisdictions including legal and regulatory requirements, this should be covered through appropriate disclosure in the financial statements to allow users to better understand and differentiate the criterion used by the reporting entity to arrive at their results (SD CLs 104 and 173). In addition, the assessment about credit risk and change in expected cash flows is naturally to some degree subjective. Additional disclosure about a firm's credit risk management processes to determine which loan resides in which bucket will help to mitigate concerns about lack of comparability among companies.
51. Also to reduce disincentives to transfer loans to Buckets 2 and 3 and to improve transparency, some staff think it would be appropriate to consider disclosure of remaining lifetime expected losses for all loans in all buckets.

Request for direction and next steps

52. The staff are concerned that a model that determines how loans should be allocated and when they should be transferred based on types of events will be difficult to operationalise and will likely be prone to avoidance.
53. Although the staff think that having a model that is based solely on the absolute credit risk of loans may not fully capture the notion of credit deterioration that the boards were seeking to incorporate in the model, it may be a more operational model. Additional outreach activities can help to confirm this.
54. On balance, the staff think that a model that focuses on credit risk management processes should be pursued further (ie Approach 2).
55. The staff recommend that such an approach (ie Approach 2) be further developed while continuing outreach activities to help determine whether Approach 2A and/or Approach 2B (considering further both watchlist notions and internal credit transfers) can be applied in an operationally feasible manner. Furthermore, the staff would like to consider how such approaches might be applied to all types of assets including consumer loans, debt securities, and single instruments.

Questions to the boards

Do the boards agree with the general direction that the staff should develop a credit risk management (ie Approach 2) approach? If not, what direction would you like us to pursue and why?

Based on the information provided, do the boards have a preference as to whether all originated loans should be classified in Bucket 1 or should it be permissible to classify originated loans directly into Bucket 2 or Bucket 3?