Purpose of this paper

1. At the June 2011 meeting, the staff presented the boards with an alternative impairment approach. The general approach was a 'three-bucket' approach that reflects the general pattern of deterioration of the credit quality of loans. For financial assets in two of the buckets or categories, the allowance balance would equal remaining lifetime expected credit losses. For the third (Bucket 1), the allowance balance would be equal to a portion of the remaining lifetime expected credit losses on the financial assets in that bucket. At that meeting, the staff presented alternative calculations for the allowance balance for Bucket 1:

    (a) **Alternative A** – recognise an impairment allowance equal to 12 months' worth of expected losses based on current loss expectations;

    (b) **Alternative B** – recognise an impairment allowance equal to a time-proportional amount of expected credit losses based on current loss expectations;

    (c) **Alternative C** – recognise an impairment allowance equal to12 months' worth of expected losses based on initial expectations plus the full amount of any changes in expected credit losses.

2. At the June meeting, the boards directed the staff to further develop Alternative C for Bucket 1. However, the boards stated that the development of this approach should focus on making sure the approach would be operationally feasible and directed the staff to perform further outreach to identify possible ways to operationalise the approach.

3. Since the June meeting, the staff and some board members have undertaken preliminary outreach with various constituents. The staff have considered the

feedback received from that process and have outlined a refinement of the 'three-bucket' approach in IASB agenda paper 7A / FASB memorandum 100 of this July 2011 meeting. This paper discusses further the feedback received on the calculation of the allowance balance for Bucket 1 and discusses the feedback we have received particularly in relation to the operational feasibility of Alternative C. The paper then presents alternative ways to calculate the allowance balance for Bucket 1 and asks the boards which approach it wishes to pursue.

4. Using that feedback, this paper presents other possible ways of calculating the allowance balance for Bucket 1. The boards' feedback on the calculation of Bucket 1 is sought to enable the staff to perform further targeted outreach of the operationality of the 'three-bucket' approach.

5. It is noted that there is some interaction between this paper and IASB agenda paper 7A/FASB memorandum 100 for this meeting in that the more forward looking Bucket 2 is (ie the quicker deteriorating loans are transferred to Bucket 2), arguably the lower the allowance balance that needs to be established for Bucket 1. However, the staff note as described in paragraph 7 of IASB agenda paper 7A / FASB memorandum 100, the overall approach discussed in that paper may be more applicable to consumer versus commercial loans. Although ideally the staff would like to develop a model that can be applied to all financial assets subject to impairment accounting, after further outreach activities are performed, the boards may decide that the calculation of Bucket 1 should differ depending on whether the loans are consumer or commercial loans.

Background and previous tentative direction

6. Based on the tentative decision at the June meeting, and as discussed in IASB agenda paper 7A / FASB memorandum 100, financial assets classified in Bucket 1 of the 'three-bucket' approach would have a portion of remaining lifetime expected losses recognised (when the remaining lifetime is greater than 12 months). In the context of open portfolios, this bucket is comprised of financial assets that are evaluated collectively and do not meet the criteria for Buckets 2

or 3. The financial assets in Buckets 2 and 3 have the full remaining lifetime expected losses recognised as the allowance balance at the end of each reporting period.

June 2011 tentative decision: Alternative C – Annual loss rate with changes recognised immediately for Bucket 1

7. **Objective for recognition of expected credit losses: To always recognise an allowance balance equal to one year's worth of expected credit losses for assets in Bucket 1with changes in expectations of the lifetime losses recognised immediately.**

8. Bucket 1 – For this approach, there are two calculations performed on the population of Bucket 1 assets. The first calculation would maintain and apply the original annual loss rate to the balance of the assets in Bucket 1. The second calculation relates to the lifetime effect of *changes* in expectations of future lifetime losses. If any change is made to those expectations, the remaining lifetime effect of the change should be recognised immediately. The total losses resulting from applying an annual loss rate to the portfolio and changes in lifetime expected losses of the portfolio would be recognised as the Bucket 1 allowance balance. The effect on profit or loss is the amount needed to adjust the balance sheet to the calculated allowance balance.

9. As outlined in the June 2011 board paper, there were some considerations the staff noted that should be addressed during outreach activities. For example, for an open portfolio, the approach may be operationally more difficult than an approach using a bright line of a 12-month or 24-month expected loss amount or using the time-proportional amount of remaining lifetime expected losses. It would be operationally challenging for an entity to distinguish between changes in expectations related to subsequent credit deterioration versus original loss expectations. Furthermore, it seems as if this alternative could require losses, loss rates, and other assumptions to be tracked on a vintage basis and, thus, would require the accounting to often be performed at a closed pool level.

10. In addition, under this alternative it may be difficult to differentiate between the second calculation that relates to the lifetime effect of *changes* in expectations of

future lifetime losses and losses under Bucket 2 (which considers total expected losses).

11. However, this alternative may be responsive to changes in expectations of losses further out in the future, and some believed that it may be easier to rationalise conceptually because the balance sheet amount represents original expectations of losses and the full effect of all changes in expectations. The boards believed that this outcome (to recognise an expectation over the life, but to immediately recognise changes in expectations) is a desirable objective, and for that reason directed the staff to try to address the aforementioned operational issues.

Feedback from preliminary outreach activities

12. As mentioned, the staff performed preliminary outreach activities with various constituents to try to identify a more operational way of applying Alternative C. Overall, the feedback was that Alternative C remained the most operationally difficult alternative. It would require significant systems changes. Constituents were concerned with the complexity of the calculation and the requirement to track data and asserted that many pools that are currently 'open' would have to be segregated and closed upon transition and on an ongoing basis. They also commented that this alternative seemed very similar to the original IASB Exposure Draft, *Financial Instruments: Amortised Cost and Impairment,* noting that the only simplification of that proposal that had been identified to date was the time-proportional approach (TPA) that was included in the joint Supplementary Document, *Financial Instruments: Impairment* (SD).

13. Some constituents also commented that if a credit migration model was followed and financial assets were transferred into Bucket 2 or 3 sooner than envisaged for the bad book in the SD, then the pressure on the allowance balance of the financial assets in Bucket 1 may be somewhat relieved. They noted in particular that if all significant deteriorations in credit quality result in a transfer out of Bucket 1 there was unlikely to be a material impact on the overall allowance balance as a consequence of any of the more complex approaches that were being considered. For this reason, they strongly suggested that the calculation of the Bucket 1 allowance be as simple as possible as the cost of the additional complexity would unlikely outweigh any incremental benefit.

14. Some participants also noted that if remaining lifetime expected losses were required to be disclosed for all financial assets subject to impairment accounting, regardless of the bucket to which they are allocated, then it may increase the acceptability of having a simpler approach for Bucket 1 that does not seek to measure the lifetime effect of changes in credit expectations.

15. Little feedback was obtained on Alternative B, TPA for Bucket 1 (ie recognise an impairment allowance equal to a time-proportional amount of expected credit losses based on current loss expectations). The only comment we received was that it was preferable to Alternative C (as it is less complex) but not as desirable as the simplicity offered by Alternative A. The EAP members we met with who were involved in the development of the TPA approach originally, confirmed that it would be operational, but argued that the incremental 'benefits' in terms of any real impact on the magnitude of allowance balances would be outweighed by the additional costs and complications of applying the TPA relative to Alternative A.

16. The staff have identified alternative methods for calculating the allowance balance in Bucket 1:

    (a) **Method A:** 12 months' worth of losses expected to occur on the financial assets, or for the remaining expected life if that is less than 12 months;

    (b) **Method B:** 24 months' worth of losses expected to occur on the financial assets, or for the remaining expected life if that is less than 24 months;

    (c) **Method C:** A simplification of Alternative C using a 'rolling' loss rate (as opposed to maintaining the original loss rate); or

    (d) **Method D:** A simplification of Alternative C using remaining lifetime expected losses of assets expected to be transferred to Buckets 2 and 3 in the next 12 months PLUS credit deterioration on remaining assets in Bucket 1.

Alternatives for Bucket 1 calculation

Method A: 12 months' worth of losses

17. **Allowance balance:** Represents 12 months' worth of losses.

18. **Profit or loss:** Amount necessary to achieve the target allowance balance.

19. This method does not attempt to simplify Alternative C. Rather, it is Alternative A from the June 2011 board paper that is a simple calculation for the Bucket 1 allowance.

20. Inputs necessary for this method:

    (a) Expected losses for 12 months after an entity's reporting date.[1]

21. When using a loss rate as the basis for expected losses (as opposed to using the nominal amount of losses without necessarily calculating a loss rate), there are a few ways a loss rate could be calculated. This will be discussed later in the paper (see paragraphs 68-78).

22. When using a loss rate (as opposed to using the nominal amount of losses), this method multiplies the annual loss rate determined by an entity to be most representative of its current predictions of the economic environment by the balance of the assets in Bucket 1 to calculate an allowance amount to be recognised on the balance sheet at the reporting date. The expected losses used shall be updated each reporting date to reflect the most recently available internal and external information. The expected losses should be determined based on all reasonable and supportable information (ie historical data adjusted for current information, including forward looking data).

23. If the average remaining life of Bucket 1 was less than 12 months, then the total remaining life expected losses would be the amount recognised as the allowance balance. This avoids allowances being recognised for more losses than they expect on the assets they currently hold.

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[1] Either a loss rate or calculating an absolute nominal amount for 12 months' worth of losses could be used to determine this amount. For example, an entity could use a 5% loss rate or could estimate CU50 of expected losses.

Advantages

24. This approach is operationally simple. One of the aspects of the general model (including the approaches recommended in IASB agenda paper 7A / FASB memorandum 100) would be to have loans included in Buckets 2 and 3 that are not considered to have 'incurred' losses today. In addition, for loans in Buckets 2 and 3 the allowance will reflect remaining lifetime expected losses. As a result, a greater total allowance balance (considering the required allowance from applying all 3 buckets) will be recognised than is the case today. The loans in Bucket 1 would generally be considered to be 'performing' (for example, paying according to the loans' contractual terms). It is anticipated that they will be moved to Bucket 2 earlier than when impairment accounting would commence in today's accounting guidance and probably earlier than proposed for the bad book in the SD. As a result, many constituents with whom we've spoken during the past few weeks have stated that complicating the calculation for the allowance in the 'performing' loan bucket (ie Bucket 1) was unduly onerous and the 'benefit' (in terms of the incremental effect on allowance balances) versus the costs are limited. They felt that this was the case because 'problem' loans and the effects of significant credit deteriorations should be captured in Buckets 2 and 3 meaning that the expectations of loss for Bucket 1 should be comparatively low. This would mean that modifying the calculation for Bucket 1, while increasing complexity would be unlikely to have a material impact on overall allowance balances. Therefore they felt that getting the split right between Bucket 1 and 2 (ie transferring loans to a whole of remaining life loss on a timely basis) would alleviate the pressure to finesse the calculations in Bucket 1.

25. They strongly encouraged that the Bucket 1 calculation should be very operationally simple so that they could focus on getting the right loans transferred at the right time to Buckets 2 and 3 for a full remaining lifetime expected loss recognition.

26. Their preference was for the measurement of the allowance in Bucket 1 to be based on 12 months' worth of losses. We heard from constituents, both internationally and in the US, during outreach on the SD that many banks already calculate a 12-month loss rate (ie what an entity expects to lose in the

next 12 months). Some stated that they calculate the 12 month expected losses for Basel or other regulatory purposes, and some stated that calculating the 12 months of losses aligns with their annual budgeting/forecasting processes.

27. In addition, although the allowance balance would not be equal to expected lifetime losses, the allowance balance would still reflect the credit quality of the loans in Bucket 1. The amount recognised as the allowance balance related to a loan with greater credit risk would be higher than for a loan with a lower loss rate. This is not to say that the amount of expected losses is required to be calculated on each loan individually. Rather to point out that while some are concerned that 12 months may not be enough for higher risk loans the allowance balance will be higher than for lower risk loans. If the loan deteriorates, it would follow the general approach and move to Bucket 2 where a full lifetime loss is recognised.

Challenges

28. There is no principle for why 12 months is used. It is simply an arbitrary amount creating a bright line in accounting guidance.

29. If an annual loss rate is used (see further discussion below) changes in expectations of losses are only reflected to the extent the change is expected in the next 12 months. Therefore, even if the information is available, this approach does not fully consider losses that may be expected later in the life of the loan. However, one way this could be addressed is to lower the threshold for moving loans into Bucket 2 so that the remaining lifetime losses of loans expected to go bad in the future are recognised sooner than under today's accounting guidance.

30. The effects of moving to Bucket 2 are significant (recognising total remaining expected life losses) so careful consideration would be needed for how to lower the threshold. This may provide a disincentive for transferring out of Bucket 1. IASB agenda paper 7A / FASB memorandum 100 further outlines this concern and provides some initial recommendations to help ensure that the timing of transferring out of Bucket 1 is clear and can be consistently applied.

31. The calculation of expected losses should be based on all available information, and would start with historical data. The loss expectation for Bucket 1 would usually be based on portfolios. Once loans are divided into Bucket 1 and Bucket 2, some staff believe it may be difficult to re-estimate the loss rate, for example, for the loans remaining in Bucket 1. Those staff believe this difficulty may arise because the historical information used may include the loss expectations for loans that have been transferred to Bucket 2. Remaining lifetime losses are also calculated on the Bucket 2 loans. So, a portion (however small) of the allowance balance may cause a 'double counting' issue (ie the loss rate applied to Bucket 1 includes a portion of the losses that are calculated on the Bucket 2 loans as well). The staff would envisage that a final standard would provide guidance that if a loss rate is used on Bucket 1, that rate should consider the consequence of transfers out of Bucket 1. However, it is noted that re-estimating the loss rate may be difficult to do, particularly on a timely basis. A similar concern was raised in the feedback we received on the SD as a result of transfers from the good book to the bad book.

Method B: 24 months' worth of losses

32. **Allowance balance:** Represents 24 months' worth of losses.

33. **Profit or loss:** Amount necessary to achieve the target allowance balance.

34. This method does not attempt to simplify Alternative C. Rather, it is a modification of Alternative A from the June 2011 board paper that is a simple calculation for the Bucket 1 allowance balance.

35. Inputs necessary for this method:

    (a) Expected losses for 24 months[2]

36. If using a 24-month loss rate, this method multiplies the 24-month loss rate by the balance of the assets in Bucket 1 to calculate an allowance amount to be recognised on the balance sheet at the reporting date. The expected losses used shall be updated each reporting date to reflect the most recent available internal and external information. The expectation should be determined based on all

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[2] Similar to Method A, either a loss rate or calculating an absolute nominal amount for 24 months' worth of losses could be used to determine this amount.

reasonable and supportable information (ie historical data adjusted for current information, including forward looking data).

37.   Similar to Method A, if the average remaining life of Bucket 1 was less than 24 months, then the total remaining life expected losses would be the amount recognised as the allowance balance. This avoids allowances being recognised for more losses than they expect on the assets they currently hold.

Advantages

38.   Similar to Method A, this approach is simple operationally (although perhaps not as simple as Method A because it would require the calculation of 24 months of expected losses, as opposed to 12 months. We understand calculating losses for 12 months is used in credit risk management today).

39.   Some are concerned that only having an allowance balance equal to 12 months' worth of losses for loans in Bucket 1 would not be a sufficient allowance. Therefore, they prefer a 24 month allowance. Arguably the case for this is even stronger if high risk loans are included in Bucket 1 as would be the case if the board adopts the relative credit risk model outlined in IASB agenda paper 7A / FASB memorandum 100.

40.   Because 24 months of losses are recognised, the effects of moving out of Bucket 1 are less significant than if the Bucket 1 allowance equates to a 12-month loss expectation. This may reduce the incentive for avoiding transfers out of Bucket 1 because the 'cliff effect' would be reduced.

Challenges

41.   Similar to Method A, there is no principle for why 24 months is used. It is simply an arbitrary amount creating a bright line in accounting guidance.

42.   Unless the 24 month amount considers remaining lifetime expected losses (see discussion related to annualised rates in paragraphs 68-78) changes in expectations of losses are only reflected to the extent the change is expected to affect the losses expected in the next 24 months.

43.   If 24 months' worth of losses are recognised at any given point in time, the 'double counting' issue described in paragraph 31 above may be even greater.

44. Currently, most entities that already calculate loss rates do so on a 12-month basis. Calculating a 24-month loss rate may not permit entities to leverage off their current processes as much as Method A (refer to paragraph 26).

45. Some think that the approach puts too much emphasis on the adequacy of the allowance balance and that this focus should be for prudential regulators rather than accounting standard setters.

Method C: Rolling loss rate

46. **Allowance balance:** Higher of:

    (a)   12 months' worth of expected losses; and

    (b)   the difference in the current rate and the average rolling rate multiplied by the balance of loans in Bucket 1 and the remaining average life of the loans in Bucket 1[3].

47. **Profit or loss:** Amount necessary to achieve the target allowance balance.

48. As a simplification of Alternative C (although outcomes will not be identical), Method C uses a rolling loss rate[4]. Method C would also have a floor of at least 12 months' worth of expected losses at the current annual loss rate.

49. The inputs necessary for this method:

    (a)   Balance of loans in Bucket 1 at end of the period;

    (b)   Weighted average remaining life of loans in Bucket 1;

    (c)   Current (ie updated) annual loss rate for loans in Bucket 1;

    (d)   Rolling average loss rate for loans in Bucket 1.

50. The rolling average loss rate is determined by taking the weighted average of the average loss rate for the previous reporting period and adjusted for the effects of the loss rates on any new loans added to the portfolio and the loans removed from the portfolio. Calculating a rolling loss rate eliminates the need

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[3] The higher of amount is necessary so that the allowance balance is never zero or negative at the end of any period.

[4] Similar to Method A, although this method is described using a loss rate, Method C could also be employed by determining nominal amounts of expected losses. In other words, instead of estimating 5% expected losses, an entity could estimate CU50 of expected losses. For purposes of explaining the method, however, this paper refers to an annual loss rate.

to track the original loss rate estimate which was one of the criticisms of Alternative C.

51. Each period an annual charge is taken in profit or loss representing the most recent reporting period's current annual loss rate multiplied by the recent reporting period's balance of loans. Also charged to profit or loss is any minimum balance adjustment necessary to ensure the allowance balance is the higher of 12 months' worth of expected losses and the effect of the difference between the current annual loss rate and the rolling annual loss rate on the remaining average lifetime. For example, for a portfolio with CU100 and an average life of 7 years remaining, if the current annual loss rate is 3% and the rolling annual loss rate is 2.5%, then the allowance balance would be the higher of:

   (a) 12 months = 3% X 100 = 3; AND

   (b) Effect of difference = (3% - 2.5%) X 100 X 7 years = 3.5

   The amount charged to profit or loss for the period would include any minimum balance adjustment necessary to ensure there was CU3.5 in the allowance account after all other activity affecting the allowance account for the year was taken into consideration.

   Advantages

52. Similar to Alternative C, the effect of changes in estimates on future periods is immediately recognised in the financial statements. However, because it simplifies Alternative C by using a rolling loss rate and because the most recent annual loss rate is used in determining the annual charge (instead of the initial estimate), the effect is not identical to Alternative C and does not provide a full 'catch-up'.

53. Eliminates one element of operational difficulty by no longer requiring tracking of initial loss rates.

54. Responsive to changes in estimates because by applying the rolling loss rate (which incorporates updated information) to the average remaining life it provides a measure of the effect on the remaining life of the period change in the loss rate.

Challenges

55. Difficult to explain (without describing the calculation) what the amounts on the financial statements represent.

56. Operationally more challenging than an approach using a 12 or 24 month expectation for the allowance balance.

57. Calculating weighted averages of the loss rates and the remaining life will require some additional work although it should be possible to do.

Method D: 12 months plus deterioration

58. **Allowance balance:** Represents remaining lifetime losses of loans currently in Bucket 1 that are expected to move to Buckets 2 or 3 in the next 12 months PLUS the effects of any deterioration in the credit quality of loans expected to remain within Bucket 1 after the next 12 months.

59. **Profit or loss:** Amount necessary to achieve the target allowance balance.

60. This method still attempts to simplify Alternative C in that it has a form of catch-up in that it recognises immediately the full deterioration/improvement of loans expected to remain in Bucket 1 longer than 12 months.

61. Inputs necessary for this method:

   (a) Remaining lifetime expected losses for loans expected to transfer out of Bucket 1 in the next 12 months;

   (b) Initial loss estimate of loans in Bucket 1 that are not expected to transfer out of Bucket 1 in 12 months; and

   (c) Updated estimate of losses for loans in Bucket 1 that are not expected to transfer out of Bucket 1 in 12 months.

62. At the end of each reporting period, an entity estimates what they expect to transfer out of Bucket 1 in the next 12 months and the remaining lifetime losses on those loans. For the loans that would remain in Bucket 1 after 12 months, the entity determines the deterioration/improvement in quality of those loans and how that affects the expected losses over the remaining lifetime. The sum of the remaining lifetime losses on loans expected to transfer out of Bucket 1

and the credit deterioration/improvement on remaining loans is recognised as the allowance balance. The amount affecting profit or loss is the amount necessary to reach that target allowance balance.

Advantages

63. Including a notion of recognising losses related to credit deterioration may remove some of the pressure on the timing of the transfer of loans out of Bucket 1. For example, if a loan's quality deteriorates such that the remaining lifetime loss estimate increases from 3 to 8, an allowance of 5 would be recognised in Bucket 1 (if the entity did not expect to transfer the loan to Bucket 2 in the next 12 months). If the updated loss estimates do not change, when the entity transfers the loan in a few years time, the allowance recognised would move from 5 to 8 (a smaller change than might occur if only a portion of the deterioration was captured in Bucket 1.

Challenges

64. Trying to identify which loans may transfer out of Bucket 1 in the next 12 months will be challenging.

65. No annual charge is recognised each period. If no loans are expected to transfer out of Bucket 1, and no deterioration occurs during the period, then there will be no charge to profit or loss that period (even though the pricing of the assets considers expectations of losses and therefore interest income includes an amount related to compensation for expected losses).

66. In order to calculate the deterioration and describe what the balance sheet represents, it is necessary to maintain the initial loss estimate. For example, assume loss expectations on the loans that remain in Bucket 1 move from 5 to 9 to 12 over three years and for simplicity assume that loans are not transferred out of Bucket 1. If the balance sheet is to be explained as the 'credit deterioration' of those loans, then at the end of the second year (when the loss estimate is 9), the allowance balance should be 4 representing the deterioration from 5 to 9. At the end of the third year, the allowance balance should be 7, representing the deterioration from 5 to 12. If the initial loss expectation of 5 is not maintained, then the entity would calculate the allowance balance at the end

of the third year as 3 (representing the deterioration from 9 to 12 that year). However, then the balance sheet does not represent the full deterioration in those loans, only the deterioration in the current year. If the approach was to recognise in profit or loss the amount of deterioration each period, depending on the other items that affected the balance sheet amount, the resulting allowance amount could be difficult to explain.

Day-1 losses

67. All the methods described above would result in some amount of day-1 losses if analysed at the level of individual loans or in acquisition scenarios. However, the approaches that we have previously developed that recognise losses over time have been criticised due to their complexity so there is a trade-off. Day-1 losses will be especially noticeable in loan portfolio acquisitions and for high-risk loans (where the 12- or 24-month expected loss could be large). However, some do not believe that this issue should be overemphasised because the open portfolio concept minimises these day-1 losses (after transition, and when in a steady state) because the loans on which the day-1 losses would be recognised (ie new loans) are replacing loans that have matured or been transferred out of Bucket 1.

Loss rate

68. The methods described above for the calculation of the allowance balance in Bucket 1 refer to a loss rate, and in some cases, an annual loss rate as a measure for expected credit losses. As already discussed by the boards at the 10-12 November 2010 meeting, the information set to be used when calculating expected losses is all reasonable and supportable information available, including historical data, current economic conditions as well as supportable forecasts of future events and economic conditions.

69. The staff thinks that the term annual loss rate[5] may be being used inconsistently and believes a common understanding should be established.

70. There are at least two ways to think about a 12-month loss rate (in each case, using all available information, eg starting with historical default information and adjusting for current information, including forward looking information):

    (a) 12-month forward looking amount (ie '**Annual**' loss rate): To develop a loss rate that reflects management's estimate of credit losses that are <u>expected to arise</u> on the portfolio of assets <u>in the next twelve months.</u>

    (b) Remaining lifetime losses divided by remaining average life (ie '**Annualised**' loss rate): To calculate <u>remaining lifetime expected losses divided by the life</u>. This is more accurately referred to as an 'annualised' loss rate. For example, if an entity expects to lose 10% over a 5 year remaining life, the annualised loss rate is 2%.

71. Therefore, the question is what outlook period should be used when adjusting the historical information in the information set used to the extent that conditions are different from those in the past? Or stated differently, how forward looking is the annual loss rate? If the outlook period is the remaining life of the loan, an annualised loss rate can be calculated (ie reflecting a long run average). Alternatively the outlook period could be 12 months in order to derive an annual loss rate that reflects the expectation for losses in the next annual period. This distinction is of great importance if either Method A or B is used for the Bucket 1 allowance because the allowance amount is limited to a 12 or 24 month calculation.

72. Reducing the outlook period especially to 12 months, but also to 24 months, would provide a simplification, particularly for smaller institutions and non-financial institutions because it may be very difficult for those entities to calculate an *annualised* loss rate starting with remaining lifetime expected credit losses. We heard much feedback through various outreach activities both on the SD and the original EDs that calculating remaining lifetime expected credit

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[5] This discussion refers to an annual loss rate. However, the same considerations or approaches could be applied to a 24-month loss rate. For example, as discussed further in the paper a 24-month loss rate could be either the losses expected to occur in the next 24 months, or the lifetime expected losses divided by the life times 2 years. With that understanding, the paper only discusses an annual loss rate to try to keep the reading smooth.

losses would be challenging, and would require significant systems/model changes, etc. As mentioned earlier in this paper, we also heard that many entities are already calculating a loss rate that determines losses expected to occur within the next 12 months.

73. In open and closed portfolios and for single loans, the annualised and annual loss will be the same if the loans on which the rate is calculated has an even loss pattern (ie, if the assets are expected to lose the same amount each period over the life of the loan). The two rates will also be the same if, for purposes of the annualised rate, an entity first calculates all expected losses (see the Appendix for an example). 'All expected losses' would be either:

    (a) Those that relate to prior years and those expected in future years related to only the loans currently outstanding; or

    (b) Any losses expected over the remaining life of the loans including an expectation for any additional loans that will be issued during that remaining life.

74. However, the staff notes that none of the ways outlined to ensure that the annual rate and annualised rate would be the same in an open portfolio are operational or necessarily realistic. For example, while it is easy to use as an example, even loss patterns exist less frequently than front-loaded or back-loaded loss patterns. So, assuming that annualised and annual rates would be similar would be unrealistic. And, determining 'all expected losses' would be operationally difficult whether that meant tracking historical estimates, or estimating how many loans will be issued and the losses that will arise on those loans in the future.

75. Furthermore, in a single or closed portfolio and for some types of instruments (eg development loans), the annual loss rate and annualised loss rate will differ because of the loss pattern. For example, assume an entity may expect to lose 10% over the next 5 years in the following pattern: 0%, 1%, 6%, 2%, 1%. The annual loss rate would be 0%, whereas the annualised loss rate would be 2%.

76. However, reducing the outlook period to a period shorter than the remaining life ignores expected credit loss information that an entity might be able to forecast. It would create an artificial cut off point irrespective of the entity's ability to

forecast losses and thereby would introduce a bright line into the impairment model. For example, assume that in the current period interest rates increase. The entity is able to estimate that the rise in interest rates will have an effect on its expected credit losses in 15 months. An annual loss rate reflecting the expectations for losses in the next year would not capture these expectations. How the loss rate is determined therefore affects how forward looking Methods A and B would be.

77. Also, if an annualised rate is used, then the rate is dependent on both the number of years remaining in the life and remaining lifetime losses. So, the annualised rate could change (even if loss expectations do not change). For example, assume remaining lifetime expected losses of CU5 for 5 years (ie annualised loss rate of 1%). At then end of the next year, the remaining life increases to 10 years but still have remaining expected losses of CU5. The annualised rate is now 0.5%.

78. Also, some staff believe that changes in loss expectations are most significantly affected by changes in the nearer term expectations (as opposed to changing the losses expected in the longer term). For example, an entity might increase their 5 year overall lifetime loss expectation from 5% to 7.5% because they expect to lose 2% (which is an increase from the original expectation of 1% each year, ie 5% / 5 years = 1%) in the next two years, and then revert back to an average 5% over the longer term, or 1% annually. Therefore, using an annual loss rate as described in paragraph 70a would capture that increase in loss expectations sooner by using the 2% rate for the next year. An annualised rate would use 1.5% (ie 7.5% / 5 years = 1.5%). Alternatively, if lifetime loss expectations are affected by losses expected further in the future, then the annualised rate would potentially be higher than the annual rate. However, the staff notes that they have repeatedly heard that entities are much more comfortable estimating losses in the nearer term than losses further in the future.

Staff recommendation and questions to the boards

79. The impairment model being developed is aiming to capture expected credit losses. Our objective is to develop a model that can be applied consistently to open/closed portfolios as well as to single instruments **and** that is operational.

80. As mentioned above and discussed further in IASB agenda paper 7A / FASB memorandum 100, the staff believe that making the impairment model more forward looking by recognising expected losses on a more timely basis than under today's 'incurred' loss model is important. By ensuring that problem loans are transferred to Bucket 2 on a more timely basis, the staff believes that the pressure to make Bucket 1 more forward looking and capable of capturing the whole of life effect of credit deterioration is lessened. Furthermore, the staff agrees with feedback from some constituents that given the quality of the loans that should be in Bucket 1 and the fact that material credit deterioration should be captured through transfers to Buckets 2 and 3, the incremental impact of changing the allowance balance in Bucket 1 through a more complex calculation is unlikely to outweigh the benefits.

81. As a result, all staff recommend that the calculation of the allowance balance in Bucket 1 be as operationally simple as possible, even though that means creating a bright line rule based on an arbitrary amount.

82. Therefore, the staff recommend Methods A and B be pursued further. The staff believes that Methods C and D will be too operationally difficult and will not provide benefits to outweigh the costs.

83. The staff have different initial views about whether a 12- or 24-month allowance is preferable for Bucket 1 for the reasons set out in this paper. However, the staff are not able to provide a firm recommendation of Method A over Method B, or vice versa, at this point because they believe that a better understanding of when loans will be transferred between the buckets is needed to establish a firm recommendation. The staff recommend that a final determination be made after further outreach is performed and the proposals regarding the transfers between the buckets discussed in IASB agenda paper 7A / FASB memorandum 100 are confirmed.
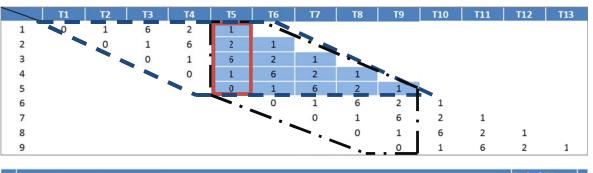
84. As mentioned above, there are concerns that an annual loss rate may not properly reflect expected losses for some types of instruments and closed portfolios when compared to an annualised rate. However, because the boards have been focused on ensuring the model is operational, the staff recommends that the operationally simpler approach be used (ie an annual loss rate or 24-month loss rate) and note within a final standard that the board is aware that this may result in some counter intuitive results in some situations (eg if losses are expected to occur late in life, the annual loss rate may be lower than an annualised loss rate). This is consistent with the staff's recommendation that the general approach to determining the allowance balance for Bucket 1 should be simple because the likely benefits of a more complex calculation are likely to be outweighed by the complexity as long as we ensure that the timing of transfer of problem loans to Bucket 2 is timely.

85. The loss rate would be estimated using all available, reasonable and supportable information to estimate losses expected to exist in the appropriate time period (ie Method A would use 12 months, Method B would use 24 months).

Questions to the boards
a) Do the boards agree with the overall staff recommendation in paragraph 81 to keep the calculation of Bucket 1 operationally simple even though that may require setting an arbitrary amount? If not, what would the boards like to do, and why?
b) If the boards agree with the overall staff recommendation, do the boards agree that Method A and B are the only methods that should be considered further at this point for the calculation of the allowance balance for Bucket 1? If not, what would the boards like to pursue, and why?
c) Do the boards agree with the staff recommendation in paragraph 84 to require the use of an <u>annual</u> loss rate (or 24-month loss rate, in the case of Method B)? If not, what would you prefer and why?

Appendix – Example for Paragraphs 70 and 73

A1.   The following tables represent a simplified example to show how an annual rate and annualised loss rate differ as described in paragraph 70. It also depicts what would be required for an annualised rate to equate to an annual rate as described in paragraph 73. The first table shows the expected losses by year, by loan, and assumes that the portfolio is in an open steady state.

A2.   The calculations as described in paragraphs 70 and 73 are performed at the end of T4. With the loss pattern shown, the annualised (70b) rate is greater than the annual rate (70a). However, an early loss pattern would show the annual loss rate being greater than the annualised loss rate. And, the second two calculations show the losses necessary to be used (ie more than those expected to occur over the remaining life of the loan as described in paragraphs 73a and 73b) in order to make the annual rate equate to the annualised rate.

	T1	T2	T3	T4	T5	T6	T7	T8	T9	T10	T11	T12	T13
1	0	1	6	2	1								
2		0	1	6	2	1							
3			0	1	6	2	1						
4				0	1	6	2	1					
5					0	1	6	2	1				
6						0	1	6	2	1			
7							0	1	6	2	1		
8								0	1	6	2	1	
9									0	1	6	2	1

	End of T4

Annual rate (paragraph 71a)	
Annual Rate (Next 12 months)	10

Annualised rate (paragraph 71b)	
Remaining expected losses	33
Average Remaining Life = (5+4+3+2+1)/5	3
Annualised Rate = Remaining expected losses / Average remaining life	11

Paragraph 74a	
Expected losses as per paragraph 74a (those related to prior years and future years related only to those loans currently outstanding – ie Loans 1-5)	50
Total life	5
Annualised Rate = Para 74a / Total life	10

Paragraph 74b	
Expected loss as per paragraph 74b (losses expected over remaining life of the loans including for loans that will be issued during that remaining life – ie EL for Loans 1-9 for T5-T9)	50
Total life	5
Annualised rate = Para 74b / Total life	10