



Project	Impairment
Topic	Three-bucket approach

Purpose of this paper

1. At the May 2011 meeting, the staff presented the boards with four high level possible alternatives for moving the impairment project forward. The alternatives were developed using feedback received on the joint supplementary document *Financial Instruments: Impairment (SD)* – a supplement to the original exposure drafts (original EDs) which addressed the impairment of financial assets.¹
2. In its meeting, the boards agreed to investigate a possible approach to impairment accounting that considers the feedback received on the previous proposals and asked a small internal working group of board members and senior staff from both the FASB and IASB to develop general models or objectives to be presented for deliberations.
3. The purpose of this paper is to present an alternative impairment approach developed by the internal working group. Within that approach there are some possible permutations that have been discussed by the internal working group.

¹ The original IASB ED *Financial Instruments: Amortised Cost and Impairment* (original IASB ED), was issued in November 2009. The FASB Proposed Accounting Standard Update *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* (original FASB ED) was issued in May 2010, and included proposals for the impairment of financial assets.

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

Comments made in relation to the application of U.S. GAAP or IFRSs do not purport to be acceptable or unacceptable application of U.S. GAAP or IFRSs.

The tentative decisions made by the FASB or the IASB at public meetings are reported in FASB *Action Alert* or in IASB *Update*. Official pronouncements of the FASB or the IASB are published only after each board has completed its full due process, including appropriate public consultation and formal voting procedures.

4. This paper outlines the broad concept for a model to enable the boards to give the internal working group and staff direction. The boards' feedback on those alternatives and the approach overall is sought to enable the staff to further develop the specifics of the model if appropriate. Throughout the development of any new approach, maximum use will be made of the feedback already received on the original EDs and the SD.

Overall model

5. The model that has been discussed by the internal working group seeks to reflect the general pattern of deterioration of the credit quality of loans – moving from being newly originated with no known default evidence, to being included within a pool with heightened credit risk but where expected credit losses for individual loans are not identified to loans for which expected credit losses can be individually identified. The impairment accounting would vary for these different 'phases'. In addition, the model seeks to be responsive to changes in information that has an effect on credit loss expectations. In all cases, the credit losses used as the basis for determining the allowance balance would consider both historical information and current information including forward looking information (ie all reasonable and supportable information).
6. Allowances would be established for all financial assets subject to impairment accounting. The model reflects the group's common starting point that dependent on the credit characteristics of a particular asset and the portfolio to which it belongs, it is appropriate to recognise full lifetime losses on some assets and a portion of losses on other assets. This is consistent with previous proposals where the allowance balance represented a portion of expected losses until, due to credit deterioration, it became appropriate to recognise full lifetime losses.
7. The model splits loans subject to impairment accounting into 3 main categories ('buckets') which determine the timing and amount of credit losses to be recognised. The allocation of loans between buckets is on the basis of the credit risk or deterioration of the loans as described further below.

8. Bucket 1 – In the context of open portfolios, this bucket is comprised of loans that are evaluated collectively that do not meet the criteria within 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, losses expected to occur over the life of the loans are not recognised. There are three alternatives for the recognition of expected losses for this bucket as described in paragraphs 16-27 below.
9. Bucket 2 – This bucket consists of assets that have been affected by the occurrence of observable events which 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 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.
10. Bucket 3 - 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 lifetime expected losses for these loans.
11. To consider the allocation of loans between the buckets and the recognition of the expected credit losses, consider the following simple example: Bank Z's entire portfolio consists of loans in Country X that includes mortgage loans in Town ABC and Town XYZ in Bucket 1. GDP decreases in Country X so that the general level of credit defaults for Bank Z's entire business in Country X increases. The decrease in GDP in itself would not cause loans to move out of Bucket 1 – however the effect of the change in credit expectations as a result of the decrease in GDP would be considered in accounting for impairment for Bucket 1. (This is considered further in paragraph 14 below).

12. Housing prices in Town ABC decline to an extent that defaults are expected to rise, so all mortgage loans to borrowers in Town ABC would be transferred from Bucket 1 to Bucket 2. Declining house prices have a direct relationship to potential future defaults but it is not clear yet which specific mortgages to borrowers in Town ABC are in danger of default. For the mortgages to Town ABC, an allowance balance equal to the full lifetime losses is recognised using the new house price information (along with all other reasonable and supportable information).
13. When the specific mortgages to borrowers in Town ABC that are in danger of default can be identified (such as where a borrower has a buy to let strategy and the rent decreased or where a borrower has to refinance its loan and the value of its house decreased), they are moved to Bucket 3. The allowance balance will be equal to full lifetime expected losses. However, the whole of life expected credit loss used as the basis for that calculation may be different from what was recognised in Bucket 2 because the loans are specifically identified now and more granular information likely exists as to what amount may be lost.
14. The effect of moving out of Bucket 1 is dramatic – the allowance balance is then based on lifetime expected credit losses. As a result, the internal working group’s assessment was that it would be appropriate to have a notion of an observable event causing loans to move to Bucket 2. This prevents all detrimental macroeconomic events causing loans to move to Bucket 2 even when the effect on a loan is very indirect. As a starting point, the working group suggest that it would be appropriate to use the triggers currently used for IBNR purposes under US GAAP and IFRS while clarifying those triggers to improve consistency of application and confirming that a default is not a prerequisite for items to move to Bucket 2. It is noted that this does not mean that the model being developed is an incurred loss model because an allowance balance would be established for *all* loans based on credit loss expectations using all reasonable and supportable information including forward looking information.

Bucket One

15. For Bucket 1 the allowance amount at each reporting date is equal to at least 12 months’ worth of expected credit losses of the assets in Bucket 1. However,

within the internal working group there were some differing opinions about the appropriate allowance balance for Bucket 1 and in particular what to do with changes in credit loss expectations. For example, what should be done if the rate of unemployment increases in Country A increasing the overall expected level of credit losses for Bank B's entire Country A business but not having a specific impact on particular products or portfolios? Assume that, initially, expected lifetime losses for mortgages in Country A were 3% and have subsequently increased to 5%. How should this increase be accounted for within Bucket 1? The alternatives build on the minimum objective of having an allowance amount equal to at least 12 months' of expected credit losses as follows:

- (a) Alternative A – recognise an impairment allowance equal to 12 months' worth of expected losses only 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 to 12 months' worth of expected losses based on initial expectations plus the full amount of any changes in expected credit losses.

Alternative A – one year's worth of losses for Bucket 1

- 16. **Objective for recognition of expected credit losses: To always have an allowance balance equal to one year's worth of expected losses for the assets in Bucket 1.**
- 17. Bucket 1 – Uses an annual loss rate multiplied 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 amount recognised in profit or loss is the amount needed to adjust the balance sheet to the calculated allowance balance. The annual loss rate used shall be updated each reporting date to reflect the most recent available internal and external information. The annual loss rate should

be determined based on all reasonable and supportable information (ie historical data adjusted for current information, including forward looking data).

18. Considerations:

- (a) Using this approach for Bucket 1, an entity would only recognise an allowance balance of one year's worth of expected losses at the reporting date. Changes in expectations of losses are therefore only reflected to the extent the change affects the 1 year forward looking loss rate. Therefore, even if the information is available, this approach does not fully consider losses that may be expected later in the life, but for which no observable event occurred that has a direct relationship to expected defaults (ie for loans that are not yet in Bucket 2). One way this could be addressed, is to lower the threshold for moving loans into Bucket 2. However, the effects of moving to Bucket 2 are significant (recognising total expected life losses) so careful consideration would be needed for how to lower the threshold (see paragraph 14). If the threshold is too low, entities may have to recognise full expected lifetime losses on much of their entire portfolio at any point in time after transition to the new impairment model.
- (b) The counter view is that this approach is simple operationally. In addition, Bucket 2 is relatively forward looking requiring loans to be moved across when the portfolio has specific problems associated with it and when assets are in Bucket 2 a lifetime loss allowance is established. This arguably reduces the pressure on the level of allowances that is required to be established for Bucket 1.

Alternative B – TPA style allowance for Bucket 1

- 19. **Objective for recognition of expected credit losses: To recognise a time-proportional amount (TPA) of expected lifetime credit losses for assets in Bucket 1.**
- 20. Bucket 1 – A TPA calculation (remaining lifetime losses multiplied by weighted average age divided by weighted average life) is performed on the balance of

this Bucket to calculate an allowance amount to be recognised on the balance sheet at the end of the period. The effect on profit or loss is the amount needed to adjust the balance sheet to the calculated allowance balance. As a practical expedient, instead of calculating full lifetime expected losses, weighted average age, and weighted average life for use in the TPA calculation, an entity could use an annual loss rate multiplied by the Bucket 1 asset balance and then multiplied by the weighted average age of the Bucket 1 assets. It is suggested that the practical expedient would be permitted because, for some entities, it may be overly difficult to calculate full lifetime expected losses.

21. The remaining lifetime losses (or, if using the practical expedient, the annual loss rate) used shall be updated each reporting date to reflect the most recent available internal and external information.
22. Using the Country A example in paragraph 15 the allowance balance would be established taking into account the increased loss expectation of 5% and the age of the portfolio. If the 5% was an estimate of total expected life losses, the weighted average age of the portfolio was 5, and its weighted average life was 10, an allowance of 2.5% of the balance of loans in Bucket 1 would be established.
23. Considerations:
 - (a) Unlike Alternative A, Alternative B considers total expected life losses (or, as a practical expedient the annual losses multiplied by the age), so Alternative B may be more responsive to changes in expectations that impact a period of greater than 12 months.
 - (b) Even though this alternative is more responsive to changes in future loss estimates, it may be difficult to rationalise conceptually. For example, if expected future losses increase, why is a portion implicitly attributed to past periods? This is a similar concern that some provided as feedback to the SD some were concerned with the difficulty of explaining what the allowance balance represents since there's a TPA amount included.
 - (c) Regardless of whether a TPA approach is used (ie remaining lifetime expected losses multiplied by weighted average age divided by

weighted average life) or if a practical expedient is used (ie annual loss rate multiplied by balance multiplied by weighted average age), a weighted average age must be calculated. Some staff believe that some entities will not be able to calculate that weighted average age.

Alternative C – Annual loss rate with changes recognised immediately for Bucket 1

- 24. Objective for recognition of expected credit losses: To always recognise one year's worth of expected credit losses for assets in Bucket 1 with changes in expectations of the lifetime losses recognised immediately.**
25. Bucket 1 – For this approach, there are two calculations performed on the population of Bucket 1 assets. The first calculation is similar to that required for Alternative A (ie apply the annual loss rate to the balance of assets in Bucket 1), although the annual loss rate is not updated as in Alternative A. 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 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.
26. For the calculation in Bucket 1, consider the following example: A closed portfolio (because this approach is easier to think about in a closed portfolio setting) comprises loans with lives of 5 years and an expected annual loss rate of 1% (assume total expected loss of 5%). At end of year 2, the total expected loss increased by 4% to 9% as a result of a macroeconomic event that affects the entire business rather than a particular portfolio in the first instance. This Alternative would require an entity to have an allowance balance equal to 1% of the outstanding portfolio at the end of each year for 5 years. At the end of year 2, the entity would recognise an additional 4% of the outstanding portfolio (the total increase in losses as a result of the increase in the life loss rate).
27. Considerations:

- (a) For an open portfolio, the approach may be less operational than Alternative A and Alternative B. For example, it would be operationally challenging for an entity to distinguish between changes in expectations related to subsequent credit deterioration versus the original expectation. In other words, if the loss rate changes on the entire balance of loans which cannot be specifically identified as having experienced credit deterioration, how can an entity determine what portion of that loss rate calculation is related to old loans (representing the 'change' in expectation) and loans that were added to the book in the current period (representing an original expectation)? Specifically, 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 the closed pool level.
- (b) Similar to Alternative B as described in paragraph 23(a), this approach is more responsive to changes in expectations of losses further out than one year.
- (c) Also, this approach 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.
- (d) Under this approach 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).

Staff recommendation and question to the boards

28. The staff believes that Alternatives A and B are difficult to explain conceptually, although they may be more operational. Alternative C, on the other hand, is easier to explain conceptually but may be more operationally difficult. However, the staff believes that the outcome of Alternative C (to recognise an expectation over the life, but to immediately recognise changes in expectations) is a desirable objective.

29. Therefore, the staff recommend that the boards consider further developing Alternative C, including determining how to make the approach operationally feasible. Further outreach would be performed to try to identify how to operationalise the approach.

Questions to the boards

1. Do the boards agree with developing an impairment model that uses the idea of three buckets as described above? If not, what would the boards like to use, and why?
2. Do the boards agree with the broad approach to distinguishing between the buckets (ie on the basis of the credit risk or deterioration of the loans as described above)? If not, how would the boards like to distinguish between the buckets, and why?
3. Do the boards agree that the allowance for both Buckets 2 and 3 should be based on lifetime expected losses? If not, what would the boards prefer, and why?
4. Do the boards agree with the staff recommendation to develop Alternative C for the calculation of the allowance balance for Bucket 1? If not, what would the boards like to do, and why?