Week beginning 13 June 2011

International Accounting Standards Board | Financial Accounting Standards Board

Impairment: Three-bucket approach

Slides to accompany
IASB Agenda Paper 8 / FASB Memorandum 99

This presentation has been prepared by the staff of the IASB and the FASB to help constituents understand the proposals in the Supplementary Document *Financial Instruments: Impairment*. The views expressed in this presentation are those of the presenters, not necessarily those of the IFRS Foundation, the IASB, the Financial Accounting Foundation, or the FASB. Official positions of the IASB and the FASB are reached only after extensive due process and deliberations.

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General overview

Guiding principle:
Reflect the general pattern of deterioration of credit quality of loans.

- Based on expected credit losses
- Responsive to changes in information that impact credit expectations
- Timing of recognition of expected credit losses depends on credit quality characteristics
- Pattern of deterioration of credit quality is captured through a three-bucket approach
- Builds on credit quality differentiation in SD

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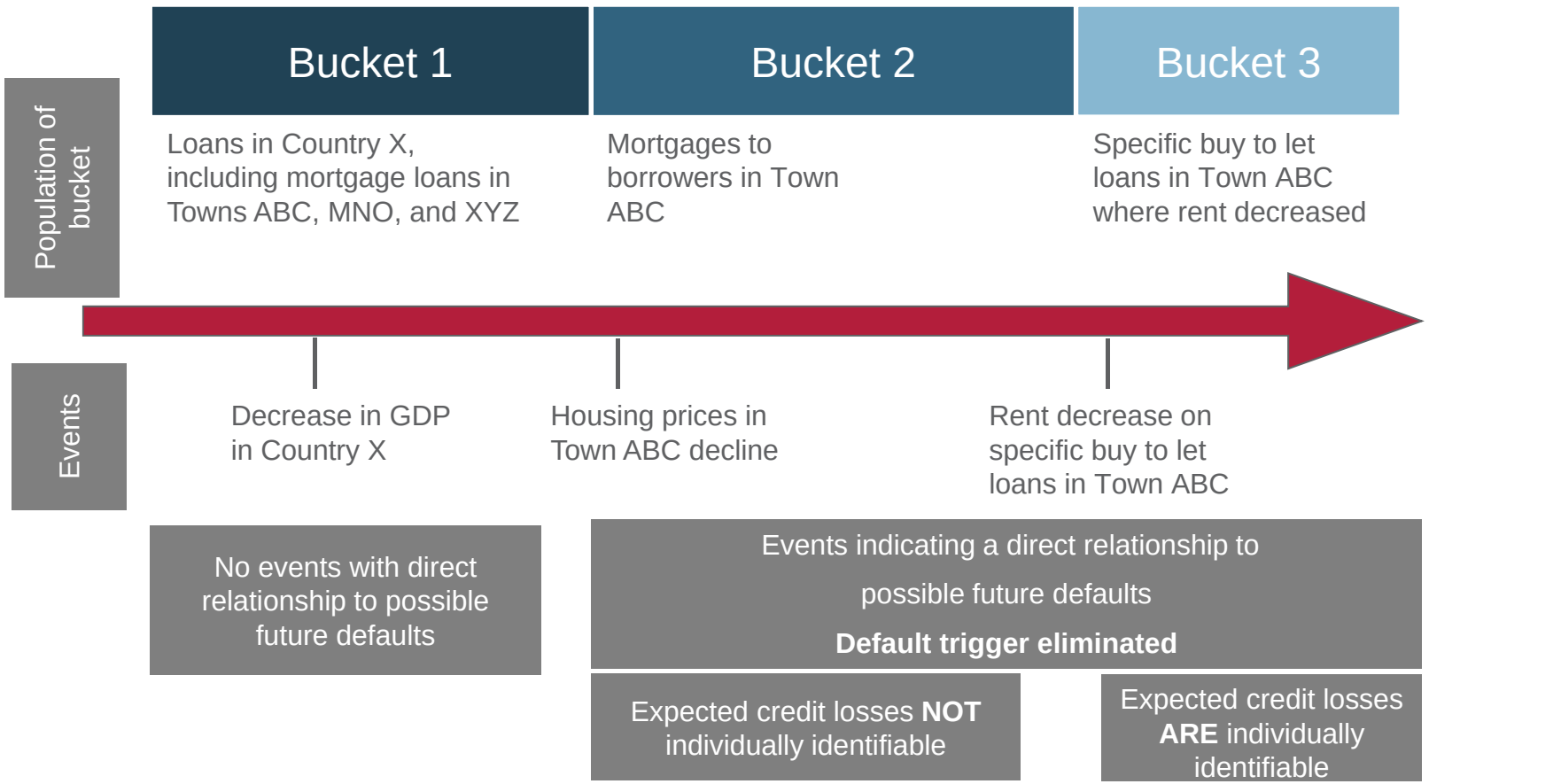
Three-bucket approach



Allowance balance

Bucket 1	Bucket 2	Bucket 3
Allowance balance equal to		
Minimum of 12 months' worth of expected credit losses*	Full remaining lifetime expected credit losses	

Three possible approaches:

- 12 months' worth of expected credit losses
- Time-proportional amount of remaining lifetime expected credit losses
- 12 months' worth of expected credit losses based on initial expectations plus the full remaining lifetime effect of any changes in expected credit losses

* Can use loss rate basis for calculation

Example of Bucket 1 Alternatives

Assumptions:				
	Year	Bucket 1 balance	Expected Lifetime Loss	Annual Loss Rate
- Credit deterioration in Year 2 in Bucket 1	t	**A**	**B**	**C** = B / WAL
- Steady State WAA* = 2.5 years	1	1000	5%	1.00%
- Life of loans = WAL* = 5 years	2	1000	9%	1.80%

Bucket 1						
Year	Alt A - 12 months		Alt B – TPA		Alt C - 12 months at initial plus full catch-up for changes in remaining lifetime	
	P/L	Allowance Bal.	P/L	Allowance Bal.	P/L	Allowance Bal.
	D	E	F	G	H	I
	= E(2) - E(1)	= A x C	= G(2) - G(1)	= A x B x WAA / WAL	= I(2) - I(1)	= A(t) x C(1) + [A(t) x (B(t) - B(1)]
1	10	10	25	25	10	10
2	8	18	20	45	40	50

* WAA = Weighted Average Age
WAL = Weighted Average Life

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Considerations

General Approach	Alternative A	Alternative B	Alternative C
The extent to which changes in information is captured in Bucket 1 (ie the Alternative used for Bucket 1) affects the importance of timing of move to Bucket 2	Operationally simple	More responsive to changes in information compared to Alternative A	Easiest to rationalise conceptually because represents original expectation of losses plus full effect of changes in remaining lifetime expectations
How to differentiate between Buckets 1 and 2 – clarify when this happens	Only one year's worth of expected loss recognised in Bucket 1 allowance balance	May be difficult to rationalise conceptually (why apportion future expectations to time period passed?)	Most responsive to changes in information compared to Alternative A and Alternative B
Moving from Bucket 1 to Bucket 2 could have a dramatic effect on allowance balance	Less responsive to changes in information compared to Alternative B and C	Must calculate weighted average age	Less operational in an open portfolio setting. May require much data tracking
			Difficult to differentiate between Bucket 1 catch-up (changes in lifetime) amount and Bucket 2 (full lifetime) amount

Questions for the boards

1. Do the boards agree with developing an impairment model that uses the idea of three buckets as presented? 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 credit deterioration of the loans as presented)? 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?

Questions or comments?

Expressions of individual views by members of the IASB and FASB and their staff are encouraged. The views expressed in this presentation are those of the presenter. Official positions of the IASB and FASB on accounting matters are determined only after extensive due process and deliberation.

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