IASB/FASB Meeting

Week commencing March 21, 2011

IASB Agenda reference	**4C**
FASB Agenda reference	**79A**

Staff Paper

Project	**Accounting for Financial Instruments**
Topic	**Addendum: Accounting for Purchased Debt Instruments subject to Impairment Accounting**

Introduction and Purpose of This Memorandum

1. Agenda Paper 4A/Memorandum 79 discussed the accounting issues related to the impairment and interest revenue recognition models for purchased loans. The focus of the paper was whether a separate interest revenue recognition and impairment model is needed for all purchased loans or a subset of purchased loans (i.e., purchased credit-impaired loans or "problem" loans).

2. As discussed in AP 4A/Memo 79, currently both U.S. GAAP and IFRS have different models for determining interest recognition for different categories of loans. Currently, IFRS only has a distinction for loans acquired at a deep discount due to incurred credit losses. Otherwise the impairment accounting for acquired and originated loans is identical. Current U.S. GAAP has a specialized model for loans with evidence of deterioration of credit quality since origination acquired by completion of a transfer for which it is probable, at acquisition, that the investor will be unable to collect all contractually required payments receivable.

3. As a result of the education sessions to discuss AP 4A/Memo79, the staff determined there is a need for clarification of the broad views presented in that paper along with a more comprehensive description of possible models for interest recognition and impairment considering both originated and purchased loans. This paper tries to provide those clarifications; however, much of this paper is a summary of the issues presented in AP 4A/Memo 79.

4. At the joint Board meeting, the staff would like the Boards to focus on the questions of:

(a) Whether the method of interest revenue recognition and impairment accounting should be consistent for all loans; that is, both purchased and originated loans (thereby removing the distinction in current US GAAP and in IFRS for loans acquired at a deep discount due to incurred credit losses)

(b) Whether there is a need to distinguish between originated and purchased loans generally or a subset of purchased loans (purchased credit-impaired loans or "problem" loans) for interest revenue recognition purposes.

General views

5. There are two broad conceptual approaches put forth by the staff:

(a) Originated and purchased loans should have *no distinction* for interest revenue recognition and recognition of impairment.

(i) For purchased loans, this means that initial expectations of credit losses on purchased loans should be treated in the same way as the initial expectations of credit losses on originated loans and changes in expectations should also be treated consistently.

Assuming that the proposals for impairment accounting in the supplementary document (SD) were to apply this would result in an impairment charge being recognized on the acquisition of a loan (due to the application of the floor) in the same way that an impairment allowance is recognized on the origination of a loan. Changes in loss expectations would be accounted for in accordance with the good or bad book as relevant. The effective interest rate would be determined by equating the contractual cash flows on the loan to the purchase price/amount lent.

(b) Originated and purchased loans should have *different models* for interest revenue recognition and recognition of impairment.

(i) For purchased loans, this means that initial expectations of credit losses would not be recognized as an impairment loss. Instead an allowance for credit losses would be established upon initial recognition resulting in

a "gross presentation" of the loan balance (because remaining expected losses attributable to the purchased loans are implicit in the purchase price). The amount of the purchase discount that would be accreted as interest revenue would reflect only the amount of cash flows expected to be collected as of the acquisition date. The effective interest rate would be determined by equating the expected cash flows to the purchase price.

6. Having a single model for originated and purchased loans means that initial credit loss expectations are recognized consistently. By virtue of the floor in the SD this would result in the recognition of an impairment loss at the date of initial recognition in both cases[1]. Creating a different model for purchased loans based on accretion of discount to expected cash flows means that initial credit loss expectations are not recognized as an impairment loss at the date of acquisition but rather as part of yield over the life of the purchased loans. This approach is similar to the model proposed for all assets measured at amortized cost in the original IASB ED.

7. Accordingly, the difference between the two conceptual approaches is the accounting for expected losses at initial recognition of purchased loans. Under both approaches, changes in credit loss expectations would be recognized in the period of the change as an impairment loss for the bad book and either all at once (based on the foreseeable future) or on a time proportionate basis for the good book.

8. The staffs believe that both views are valid and are possible avenues for the Boards to pursue. The differences in outcome of the models relate to the timing of recognition of income for purchased loans and the presentation within the income statement of interest versus credit losses. At the end of the life of the pool of purchased loans, the net amount of income recognized is the same under both approaches. If actual losses equal expected losses, then the amount of income recognized would be based on the cash flows initially expected to be collected.

[1] Note that using the time proportional model in the IASB only model, an acquired good portfolio would be treated as having an age of zero so an impairment allowance for acquired loans in the good book would only be recognized over time consistent with the treatment of originated loans.

9. A key consideration in resolving this issue is whether there is any valid reason to have a different model for originated and purchased loans. For open pools of originated loans, the impairment model in the SD gives rise to an immediate impairment charge for each loan introduced into the pool. (The part of the SD model that would result in this immediate impairment charge is the foreseeable future floor, or, for a pool of loans acquired directly into a bad book, the requirement to recognize the full expected remaining life loss.) A question is why a purchase of a pool of loans should not give rise to the same result—recognition of a credit impairment loss upon acquisition.

10. However, while acknowledging that is a valid question, some make a distinction between originated loans and purchased loans. For originated loans, some view the interest rate that is charged as compensating for a risk of loss that manifests only at a pool level but not possibly allocating that expected loss to the individual loans in that pool. Therefore, the expected loss for originated loans arises because of the pool technique. When a pool of loans is purchased at a discount, while the discount cannot be explicitly separated into a component related to the changes in the benchmark rate versus other components including credit from the time of origination, the purchaser often has a clear expectation of loss for the pool that is evident in its determination of the price that will be paid for the pool. The expectation of loss is based on the purchaser's assessment of what has already happened for this specific pool and evidence that the pool has an embedded expected loss, but that the actual losses have not yet emerged. Since the purchase price explicitly takes into account the loss expectation, some view recognizing an immediate impairment charge and reducing the carrying value of the purchased pool below its purchase price at initial acquisition as counterintuitive.

11. Others view the notion of expected losses as being identical for originated and purchased loans. In their view an entity must assess loss expectations in order to establish the appropriate pricing on origination. All loans are considered to have expected losses on origination based on the specific features of the loan and obligor and knowledge of the performance of similar loans. Similarly, in acquiring a loan an entity must determine the appropriate price given loss expectations at the time of purchase. As the interest rate is already established

the adjustment is necessarily made through the purchase price rather than in a change to the contractual interest rate. However, the staff members supporting this view see this as the only difference and regard the concept of expected losses in the same way in both scenarios thus supporting consistent accounting for impairment losses under an expected loss model.

Approaches for discussion considering both originated and purchased loans

12. Based on the discussion above, the following are the three specific approaches the staff would like the discussion to focus on (these align loosely with the alternatives presented in AP 4A/Memo 79, Issue 2 on discount accretion):

    (a) **Approach 1**: *Single model for all originated and purchased loans*—recognize interest based on contractually required cash flows for all loans; account for impairment consistently (so recognize impairment loss immediately for all loans based on the model in the SD).

    (b) **Approach 2:** *Two models differentiating between purchased credit-impaired loans and all other loans ('good' originated and purchased loans)*—Same as Approach 1 for originated loans and purchased loans that are not at a deep discount due to credit losses. For loans purchased at a deep discount due to credit, recognize interest based on cash flows expected to be collected and no immediate recognition of impairment loss. *(original IASB staff view in AP 4A/Memo 79)*

    (c) **Approach 3:** *Two models differentiating between originated and purchased loans*— Same as Approach 1 for originated loans; for all loans purchased at an amount that includes a discount attributable to credit, recognize interest based on cash flows expected to be collected and no immediate recognition of impairment loss (purchase price "grossed up" to establish an impairment allowance). *(original FASB staff view in AP 4A/Memo 79)*

13. The paragraphs below describe of the features of the models and outline some pros and cons. The full model for interest recognition is still to be developed (including considering the definitions of amortized cost under both IFRS and US

GAAP) along with determining issues such as whether expected losses should be discounted and whether non-accrual guidance is required. The analysis below should therefore be viewed as being an overview for illustrative purposes and is subject to refinement.

Approach 1

(a) For both originated and purchased loans, interest income would be recognized based on the contractually required cash flows. EIR for originated loans is the rate that equates the loan amount and the contractually required cash flows and EIR for purchased loans is the rate that equates the contractual cash flows and the purchase price. In effect, the EIR is free of expected credit loss resulting in a higher rate. This is consistent with the measurement of EIR under U.S. GAAP and IFRS today (except for purchased loans acquired at a deep discount).

(b) Interest revenue would be determined by applying EIR to the amortized cost (amount funded/price paid) excluding the allowance for credit losses for all loans. This would require the FASB to change its view from the proposed guidance in the 2010 ED and would require the IASB to redefine amortized cost to exclude incurred credit losses; these definitions would then be aligned. Without changing the definition of amortized cost, recognizing an impairment expense upfront and determining interest revenue by applying EIR to a net amortized cost balance result in both reflecting the reduction of income as an impairment loss and through lower interest revenue.

(c) For purchased loans, the full purchase discount is accreted as interest revenue over the term of the loans.

(d) Due to applying the SD for both originated and purchased loans, an impairment expense would be recognized immediately upon initial recognition to establish an allowance for credit losses. (For loans acquired into a good book, the amount of impairment expense is automatically the floor—the foreseeable future amount of credit

losses; for loans acquired into a bad book, the amount of impairment expense is the full expected remaining life loss.)

(e) Recognizing contractual interest on all loans, including purchased credit-impaired loans, would create a need to consider guidance on when to cease accrual of interest. This issue (nonaccrual) will be discussed at a future Board meeting.

Pros

(a) Fully aligns the accounting for originated loans and purchased loans in terms of the following:

  (i) recognizing all loans at their initial fair value less an allowance for credit losses at initial recognition

  (ii) recognizing interest revenue based on the contractually required cash flows

  (iii) recognizing an impairment expense consistently (upon origination/acquisition based on the SD proposals).

(b) Avoids the need to address the issue of how to handle changes in expectations above originally expected cash flows since interest would be recognized based on contractually required cash flows and credit related changes would be reflected in the allowance account (i.e., Issue 3 in AP 4A/Memo 79 would not need to be addressed).

(c) Some staff believe that this approach improves comparability because it would result in identical accounting for an acquired loan and a purchased loan for the same amount invested, at the same yield, over the same maturity when expected losses are the same.

Cons:

(a) Accreting interest on purchased credit-impaired loans based on the contractual cash flows cause some to be concerned that interest revenue would be overly inflated and impairment expense overstated in the periods they are recognized (that is, the timing differences and the potential that looking at these in isolation will mislead readers of

financial statements); hence some believe this heightens the need for nonaccrual guidance.

(b) As noted earlier, some staff believe that recognizing an expense for credit losses for purchased loans seems counterintuitive when the purchase price reflects cash flows expected to be collected. The other staff view accounting for originated loans as arguably having the same counterintuitive result when the loan is priced on market terms at origination.

Approach 2

(a) For originated loans and acquired loans (except those that are acquired at a deep discount due to credit impairment), interest income would be recognized based on the contractually required cash flows. EIR for these loans is the amount that discounts the contractual cash flows to the amount advanced/purchase price. Interest revenue would be determined by applying EIR to the amortized cost (amount funded). It is assumed for the analysis in this paper that amortized cost excludes any impairment allowance, acknowledging that the boards will have to determine whether the definitions of amortized cost under both US GAAP and IFRS should be consistent.

(b) For purchased loans acquired at a deep discount due to credit losses, interest income would be recognized based on cash flows expected to be collected. EIR is the rate that equates cash flows expected to be collected and the purchase price. Interest revenue would be determined by applying EIR initially to the purchase price – the carrying amount would accrete over time to the expected cash flows. Only the portion of the discount reflecting amounts expected to be collected is accreted as interest revenue.

(c) EIR is "locked" at initial acquisition (to try to address operational concerns about today's model in ASC 310-30/SOP 03-3)

(d) For originated and most purchased loans, an impairment loss would be recognized immediately upon initial recognition. For purchased

credit impaired loans, only changes in expected losses would be recognized in income with the original loss expectations being reflected in the EIR.

(e) Consider need for guidance on when to cease accrual of interest.

Pros

(a) The accounting for most loans—originated loans and most purchased loans—is aligned.

(b) Does not accrete the full discount on loans purchased at a deep discount due to credit so that interest revenue does not appear inflated.

(c) Since this is roughly the model that is currently required (with a simplification of not adjusting yield after initial recognition), there would not be new operational problems. Locking EIR addresses some of the operational concerns of ASC 310-30.

(d) The treatment for problem loans is consistent with IFRS today for loans acquired at a deep discount due to incurred credit losses. The IASB staff is not aware of any issues in implementing those requirements today. It is also consistent with the original IASB ED but does not appear to have the same operational challenges as were raised with broad application of that model.

(e) If the bad book distinction is retained from the SD it could be used as a basis to determine to which loans this approach should apply.

Cons:

(a) Retains the current distinction in both US GAAP and IFRS between purchased credit-impaired loans and non-credit-impaired loans. This creates need to be able to define this subset of loans. The IASB staff is not aware of concerns currently under IFRS.

(b) Still need to address the issue of how to handle changes in expectations above originally expected cash flows for this subset of purchased loans. (See Issue 3 in AP 4A/Memo 79)

Approach 3

(a) For originated loans only, interest income would be recognized based on the contractually required cash flows. EIR for originated loans is the discount rate that equates the contractual cash flows to the amount advanced. Interest revenue would be determined by applying EIR to the amortized cost, which would not include a reduction for any impairment allowance.

(b) For all loans purchased at an amount that reflects a discount attributable to credit, interest income would be recognized based on cash flows expected to be collected upon acquisition. EIR is the rate that equates cash flows expected to be collected and the purchase price. Interest revenue would be determined by applying EIR to the amortized cost (which would initially be the amount paid and then would accrete to the expected cash flows over time). Only the portion of the discount reflecting amounts expected to be collected is accreted as interest revenue.

(c) EIR is determined based on the cash flows expected to be collected at initial acquisition and is 'locked' in at this rate (to try to address operational concerns about today's model in ASC 310-30/SOP 03-3). Changes in expectations from acquisition would adjust the initial allowance but would not be taken into account in the determination of interest revenue (they would increase or decrease the allowance and net income).

(d) For originated and purchased loans with no discount attributable to credit, an impairment loss would be recognized immediately upon initial recognition. For loans purchased at a discount that includes credit, an impairment allowance would be established by "grossing up" the purchase price for the allowance required under the SD. Additionally, changes in expectations would be recognized in income and as an adjustment to the allowance recognized at acquisition.

(e) Consider need for guidance on when to cease accrual of interest.

Pros

(a) Does not accrete full discount on loans purchased at a discount due to credit so that interest revenue does not appear inflated.

(b) The accounting for purchased loans acquired at a discount does not distinguish based on the level of deterioration of credit quality of the purchased pool. It does not require a definition that would distinguish loans acquired at a deep discount.

(c) This would alleviate the operational burden under current GAAP and IFRS that would continue under Approach 2 to individually identify impaired loans within an acquired pool and account for those separately. However, at least some staff believe that the good/bad book categories (if finalized) could be used as a basis for this distinction. (Some staff members believe that the Boards would need to clarify the circumstances under which an entity would acquire a pool of loans directly into the bad book. Others believe that in the same way that management would determine when good loans would move to the bad book they could equally determine when a purchased loan would be put into the bad book.)

Cons:

(a) Retains a distinction between originated loans and purchased loans where one should not exist in the accounting framework. Some may assert that eliminating this distinction fully would be the only approach that would resolve the complexity in interpreting reported information and operational complexity that have been expressed in the U.S. Additional information (such as contractually required cash flows for pools of purchased loans) could be provided through disclosure to aid in analysis.

(b) The IASB staff are concerned that requiring the adjustment of EIR to reflect initial credit loss expectations will give rise to the operational challenges that were raised in relation to the IASB's original ED that included this approach to deal with initial loan loss expectations. The FASB staff understand that the key complexities associated with the

model for purchased credit-impaired loans in the U.S. relates to the revisions of yield upward due to improved expectations of cash flows expected to be collected and downward due to adjusting the carrying amount for decreased expectations of cash flows expected to be collected and continuously re-estimating expected cash flows.

(c) Some staff are also concerned that by combining the two approaches operational challenges will arise because entities will need to track which of their loans were originated and which were acquired for purposes of interest income recognition. If loans are acquired and subsequently accounted for in existing open portfolios this could be challenging. This could be mitigated if purchased loans are tracked as closed pools, but the staff would not want to explicitly require this. Also, some staff question to what extent this is practical given that the proposals are not limited to acquisitions of portfolios or to business combinations so could in principle apply to acquisitions of single or small portfolios of loans. The staff could conduct outreach to assess practical issues.

(d) Still need to address the issue of how to handle changes in expectations above originally expected cash flows for purchased loans. (See Issue 3 in AP 4A/Memo 79)

Questions for the Boards

Should originated loans and purchased loans (or any subset of purchased loans) have the same or different accounting models for interest income recognition and recognition of credit impairment losses?

What is the preferred approach (see paragraph 12)?

If the Boards select an approach based on accreting to expected cash flows, would this be applied for all loans purchased at a discount (regardless of the extent of the discount) or only for loans purchased at a deep discount due to credit or that are purchased directly into the bad book (Approach 2 versus Approach 3 in par. 12)?

If the Boards select an approach based on accreting discount to expected cash flows for any subset of purchased loans, how should favorable changes in

expectations be accounted for? (See Issue 3 in AP 4A/Memo 79)