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

Introduction and background

1. On Tuesday 22 March, the boards discussed the interest recognition and impairment models for purchased financial assets subject to impairment accounting. The relevant board papers were IASB agenda papers 4A and 4C - FASB memos 79 and 79A.
2. In order to reach decisions on that issue, the boards requested that the staff bring back some examples illustrating the application of the alternative approaches with some simple fact patterns. The examples focus on 'good book' acquisitions as these are the loans for which there are different staff views on the appropriate accounting, as was summarised in the earlier purchased loan papers.
3. This paper sets out scenarios for discussion and **repeats the questions from the earlier IASB agenda paper 4C/FASB memo 79**. As background information, the appendix to this paper shows the numerical analysis supporting the numbers referred to in this paper.
4. The accounting for originated loans shown in the paper assumes application of the proposals in the Supplementary Document.

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.

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Comparison of originated loans[1] and purchased loans

5. The following assumptions are made in these examples:

   (a) In all scenarios the originated loan or purchased loan goes into the good book on initial recognition.

   (b) The initial loss expectations (ie the expectations as at the date of initial recognition by Lender Z, Y and W in the scenarios below) are realised.

   (c) The discounting of expected losses is ignored for the purposes of simplicity and because this issue is still open.

Scenario one

6. On 31 March 2011 Company A wants to borrow money on a zero coupon basis repayable on 31 March 2014. The contractual amount due on 31 March 2014 is CU 100m.

7. On 31 March 2009 Company A issued another zero coupon bond – that is also repayable on 31 March 2014. The contractual amount due on that bond is also CU 100m.

8. The credit quality of Company A has deteriorated since 31 March 2009.

9. On 31 March 2011 Lender Z can choose to advance monies to Company A under the new bond or to buy the outstanding bond. In both cases Lender Z's expectation of loss based on the reasonable and supportable information it has available (taking into account what it knows about Company A, its past performance and the performance of like credits and instruments in the past and its assessment of the future) is CU 5m, all of which is attributed to the foreseeable future.

10. Lender Z is indifferent between lending under the new facility or acquiring the existing facility. Lender Z determines that it is willing to lend/pay CU 82m in both cases.

[1] The term 'loans' is applied as short hand. The illustrations apply equally to all debt instruments subject to impairment accounting.

Originated loan (Supplemental Document (SD) approach)

	Balance sheet on initial recognition	Income statement	Year 1	Year 2	Year 3
Amount lent	82	Revenue[2]	5.61	5.99	6.40
Allowance for losses	(5)	Loan losses	(5.00)		
Net carrying amount	**77**	Net income	0.61	5.99	6.40

The yield reported in the income statement on the originated loan is 6.84%

Purchased loan

Approaches 1 and 2[3]	Balance sheet Day 1	Income statement	Year 1	Year 2	Year 3
Purchase price	82	Revenue	5.61	5.99	6.40
Allowance for losses	(5)	Loan losses	(5.0)		
Net carrying amount	**77**	Net income	0.61	5.99	6.40
Approach 3	Balance sheet Day 1	Income statement	Year 1	Year 2	Year 3
Loan	87	Revenue[4]	4.12	4.33	4.55
Discount for losses	(5)	Loan losses			
Net carrying amount (price paid)	**82**	Net income	4.12	4.33	4.55

The yield reported in the income statement on the purchased loan:
Approaches 1 & 2 = 6.84%
Approach 3 = 5.03%

Scenario 2

11. Company B wants to borrow money for a 5 year term (repayable on 31 March 2016). Due to Company B's cash flow profile it requests a specific payment profile that capitalises interest to some extent (ie the cash paid on a periodic basis is slightly below the market rate of interest).

12. Given the credit quality of Company B, Lender Y requires a contractual return of 5.95% on the facility. To accommodate Company B's cash flow

[2] Accreting to contractual cash flows because the impairment due to initial loss expectations is separately recognised in the income statement.
[3] Approaches 1 & 2 are the same for loans acquired into the good book.
[4] Accreting to expected cash flows because the impairment due to initial loss expectations is not separately recognised in the income statement.

constraints, Lender Y is willing to lend Company B a loan of CU 960 with an annual payment in years 1-5 of CU 50 (each due on 31 March) and a bullet amount due on 31 March 2016 of CU 1,000. That gives Lender Y an overall contractual yield of 5.95%.

13. Alternatively, Lender Y could buy an existing bond that was issued by Company B several years ago. It was originally issued at par of CU 1,000 with a contractual interest rate of 5%. The principal amount of CU 1,000 is repayable on 31 March 2016 and all interest payments (of CU 50) are due annually on 31 March.

14. The contractual cash flow payments are assumed to be identical on the instruments. The expectations of loss on both instruments are identical. In both cases Lender Y expects that Company B will only pay 97% of each contractual payment (considering information about Company B along with information about like credits in a similar portfolio).

15. Lender Y is indifferent between paying CU 960 for the existing loan or advancing CU 960 under the new facility.

16. Ignoring discounting for the sake of simplicity (and because it does not affect the overall analysis given the cash flow profiles are identical), expected losses are CU 37.5. It is also assumed for simplicity that the full loan term is considered to be the foreseeable future.

Originated loan (SD approach)

	Balance sheet on initial recognition	Income statement	Year 1	Year 2	Year 3	Year 4	Year 5
Amount lent	960	Revenue[5]	57.1	57.53	57.97	58.45	58.95
Allowance for losses	(37.5)	Loan losses	(37.5)				
Net carrying amount	**922.5**	Net income	19.6	57.53	57.97	58.45	58.95

Originated Loan Yield reported in the income statement = 5.95%

Purchased loan

Approaches 1 and 2	Balance sheet Day 1	Income statement	Year 1	Year 2	Year 3	Year 4	Year 5
Purchase price	960	Revenue	57.1	57.53	57.97	58.45	58.95
Allowance for losses	(37.5)	Loan losses	(37.5)				
Net carrying amount	**922.5**	Net income	19.6	57.53	57.97	58.45	58.95
Approach 3	Balance sheet Day 1	Income statement	Year 1	Year 2	Year 3	Year 4	Year 5
Loan	997.50	Revenue[6]	50.3	50.4	50.5	50.6	50.7
Discount for losses	(37.5)	Loan losses					
Net carrying amount	**960**	Net income	50.3	50.4	50.5	50.6	50.7

Purchased Loan Yield reported in the income statement:
Approaches 1 & 2 = 5.95%
Approach 3 = 5.24%

Scenario 3[7]

17. Lender W wants to increase its share of the high yield lending business.

18. Lender W can do that by originating a portfolio of new loans to a group of high yield borrowers. Lender W would be willing to lend CU 100m for a 5 year term to this group of borrowers at a contractual interest rate of 20% pa. Lender W's expected yield is 12.15% on these new loans.

[5] Accreting to contractual cash flows because the impairment due to initial loss expectations is separately recognised in the income statement.
[6] Accreting to expected cash flows because the impairment due to initial loss expectations is not separately recognised in the income statement.
[7] The purchase price, expected yield and expected losses on the originated loans and the purchased loans are identical. However, the cash flow profile is different as the earlier payments on the originated loans are higher given the higher contractual interest rate so that total interest paid on the purchased loans is higher reflecting their longer duration

19. Alternatively Lender W has been offered the opportunity to buy a portfolio of loans with a remaining maturity of 5 years that were made to the 'same' group of borrowers. This group of borrowers were originally not high yield borrowers and the portfolio of loans has a contractual interest rate of 7.5% and a principal amount of CU 154.2m. Lender W views this portfolio as having the same risk as the new portfolio it is contemplating originating, so would also require a yield based on the expected cash flows for the 5 year investment of 12.15 % pa – based on this yield requirement Lender W would be willing to pay CU 100m for this existing portfolio.

20. The expected shortfall in cash flows in both cases (originated and existing loans) is the same - CU 50m at year 5.

21. Lender W is indifferent economically between originating the new portfolio and acquiring the existing portfolio.[8]

22. It is noted that this analysis assumes that although the portfolio is high yield it is still considered to be a good book portfolio. If the loans were part of a bad book portfolio both the IASB and the FASB staff would recommend that an approach like that portrayed as approach 3 would be appropriate.

23. The definitions of 'good book' and 'bad book' are not yet finalised as well as when loans would be put into these books, as this is subject to redeliberations of the SD.

[8] Clearly this is simplistic and ignores factors such as any differences in the cost of originating loans through a new business versus undertaking due diligence to purchase someone else's portfolio.

Originated loans (SD approach)

	Balance sheet At initial recognition	Income statement	Year 1	Year 2	Year 3	Year 4	Year 5
Amount lent	100m	Revenue[9]	20	20	20	20	20
Allowance for losses	(50m)	Loan losses	(50)				
Net carrying amount	**50m**	Net income	(30)	20	20	20	20

Originated Loan Yield reported in the income statement = 20%

Purchased loans

Approaches 1 and 2	Balance sheet Day 1	Income statement	Year 1	Year 2	Year 3	Year 4	Year 5
Purchase price	100m	Revenue[10]	18.9	20.3	22	24	26.4
Allowance for losses	(50m)	Loan losses	(50)				
Net carrying amount	**50m**	Net income	(31.1)	20.3	22	24	26.4
Approach 3	Balance sheet Day 1	Income statement	Year 1	Year 2	Year 3	Year 4	Year 5
Loan	150m	Revenue[11]	12.15	12.2	12.3	12.4	12.5
Discount for losses	(50m)	Loan losses					
Net carrying amount (purchase price)	**100m**	Net income	12.15	12.2	12.3	12.4	12.5

Purchased Loan Yield reported in the income statement:
Approach 1&2 = 18.93%
Approach 3 = 12.15%

Questions for the boards

Should originated loans and purchased loans purchased into the good book have the same accounting model for interest income recognition and recognition of credit impairment losses (Approach 1 in AP 4C/Memo 79A)? Or do the boards want to treat all loans purchased at a discount for credit differently

[9] Accreting to contractual cash flows because the impairment due to initial loss expectations is separately recognised in the income statement.
[10] The difference in profile between the originated loans and approaches 1 and 2 arises because the acquired portfolio has a low contractual coupon so that there is a zero coupon component economically in the purchased loans whereas the newly originated loans have a higher contractual coupon.
[11] Accreting to expected cash flows because impairment due to the initial loss expectations is not separately recognised in the income statement.

(whether purchased into the good or the bad book) (Approach 3 in AP 4C/Memo 79A)?

Assuming the boards choose to accrete to contractual cash flows for all good loan acquisitions, would the boards want to accrete to expected cash flows for loans acquired into the bad book (Approach 2 in AP 4C/Memo 79A)?

If the Boards select an approach based on accreting the discount to expected cash flows for any subset of purchased loans, how should favourable changes in expectations be accounted for (see Issue 3 in AP 4A/Memo 79)?