Agenda paper 2

International Financial Reporting Standards

Financial Instruments: Impairment

The views expressed in this presentation are those of the presenter, not necessarily those of the IASB or IFRS Foundation.

Classification model for financial assets

Business model test

Contractual cash flow characteristics

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Amortised cost (one impairment method)

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FVO for accounting mismatch (option)

Reclassification required when business model changes

All other instruments:
- Equities
- Derivatives
- Some hybrid contracts
- …

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Fair Value (No impairment)

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Equities: OCI presentation available (alternative)

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Amortised cost
– An entity’s business model

- Business model
  - objective of holding instruments to collect or pay contractual cash flows rather than to sell prior to contractual maturity to realise fair value changes
  - not an instrument by instrument approach to classification
  - assess contractual terms of instruments within such a business model

Amortised cost – Contractual cash flow characteristics

Contractual cash flow characteristics

Contractual terms that give rise to solely payments of

Principal

Interest

Interest =
Consideration for
- time value of money
- credit risk

Sovereign debt under IFRS 9

- Would be classified at amortised cost (if held to collect contractual cash flows)
- No more AFS, so no transfer of losses between OCI and P&L
- Sovereign debt at amortised cost would be subject to impairment model being developed

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General overview

<u>Guiding principle</u>:

Reflect the general pattern of deterioration
of credit quality of financial assets.

- Based on expected credit losses (EL)
- Responsive to changes in information impacting credit expectations
- Pattern of deterioration of credit quality is captured through a three-bucket approach
- Timing of recognition of EL depends on credit quality deterioration/level

Credit Quality Approach

	Bucket 1	Bucket 2	Bucket 3
Credit Risk	Low to Medium	Medium to High	High to Very High
Transfer between Buckets 1- 3		(a) An expected deterioration in financial performance of the borrower that results in a change in credit risk to medium/high, together with (b) an increase in uncertainty about the ability to recover cash flows.	(a) A deterioration in financial performance of the borrower that results in a change in credit risk to high/very high, together with (b) expected non-recoverability of cash flows.

- Internal credit categories need to be mapped to buckets.
- As loans are purchased or originated, they are classified in one of the three buckets in accordance with level of credit risk (eg credit rating).
- Loans migrate downward or upward into another bucket depending on the change in credit quality/rating (ie the ‘new’ level of credit risk/credit rating).
- Newly originated higher credit risk loans would be in Buckets 2 or 3.

* ‘Loans’ is used as shorthand for financial assets subject to impairment accounting.

Bucket 1 Approach

	Bucket 1	Bucket 2	Bucket 3
Credit Risk			
Transfer between Buckets 1 - 3	All financial assets originated or purchased* are initially classified in this bucket.	(a) An expected deterioration in financial performance of the borrower together with (b) an increase in uncertainty about the ability to fully recover cash flows.	(a) A deterioration in financial performance of the borrower together with (b) expected non-recoverability of cash flows.

- Same as Quality Approach <u>except</u> all purchased and originated loans start in Bucket 1 irrespective of credit quality.
- Acknowledges link between pricing and credit risk <u>and</u> inappropriateness of recognising full lifetime losses on loans priced at market.

* Except those purchased at a deep discount, which will be discussed later by the boards.

Allowance balance

Bucket 1	Bucket 2	Bucket 3
Allowance balance equal to:		
Two possible approaches: • 12 months' worth of EL* • 24 months' worth of EL*	Full remaining lifetime EL	Full remaining lifetime EL

- The boards have not yet decided on the measurement of Bucket 1 allowance.
- In October, the boards will consider another alternative that would measure:
  - Bucket 1 – 12 months' worth of EL
  - Bucket 2 – 24 months' worth of EL
  - Bucket 3 – full remaining lifetime EL

* Can use loss rate basis for calculation

Questions for CMAC members (1 of 3)

1. Do you think financial assets should initially be grouped according to:
   – the level of credit quality (the Credit Quality Approach), or
   – should all assets start in Bucket 1 irrespective of credit quality (the Bucket 1 Approach)?
2. Do you think the three-bucket approach described above is appropriate, or would a two-bucket approach (ie merging Buckets 2 and 3 into one) be sufficient?
3. Where do you think the dividing lines should be between
   – Buckets 1 and 2, and
   – Buckets 2 and 3?

Questions for CMAC members (2 of 3)

4. Which of the following do you think the measurement of the expected losses (allowance) in Bucket 1 should be based on? Does your answer depend on your answer to question 3?
   – 12 months of expected losses?
   – 24 months?
   – something else (if so, what?)?

5. Do you think the measurement of the allowance in Bucket 2 should be based on lifetime expected losses, or something else?

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Questions for CMAC members (3 of 3)

6. Given the three-bucket approach, what disclosures would be useful in your analysis?

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Next steps

- Further Board discussions:
  - Develop a Credit Quality Approach, but address situations with significant day-1 losses including business combinations and purchased loans
  - Focus on developing further when to transfer between the buckets
  - Address measurement within Buckets 1 and 2
- Continued outreach activities
- ED or review draft in first half of 2012

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Questions or comments?

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