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CONTACT(S)			
	Sara Glen	**sglen@ifrs.org**	**+44 (0)20 7246 6933**
	Jana Streckenbach	**jstreckenbach@ifrs.org**	**+44 (0)20 7246 6473**
	Chris Roberge	**ceroberge@fasb.org**	**+1 203 596 5274**
	Rosemarie Sangiuolo	**rsangiuolo@fasb.org**	**+1 203 596 3426**

Purpose of the paper

1. The Cover Memo, IASB Agenda Paper 3/FASB Memorandum 112, provides a brief background to the topic addressed in this paper.
2. As mentioned in that Cover Memo, the boards directed the staff to explore how, within the context of a Credit Quality Approach[1], to minimise the day 1 lifetime loss effect for entities whose ‘primary’ business model is to originate financial assets at lower credit quality levels (the definition of ‘lower credit quality levels’ is yet to be determined). In other words, these are entities that primarily engage in origination of assets outside Bucket 1. This paper addresses considerations for dealing with those entities. In addition, for reasons described below, three of the alternatives discussed could be applied to all entities.
3. This paper does NOT address the treatment of purchased assets at lower qualities, including those in a business combination. That discussion is included in IASB Agenda Paper 3B/FASB Memorandum 114.
4. This paper also does NOT address which credit qualities are included in the different buckets and at what point to transfer assets between Buckets 1, 2, and 3. That will

[1] The Credit Quality Approach is a three-bucket impairment approach in which buckets are aligned with the credit quality of financial assets.

continue to be discussed at a later meeting. However, the staff note that if the split between Buckets 1 and 2 is at a higher credit quality level, then the issue to be addressed in this paper affects more assets than if the line is drawn at a lower level. Consequently, the magnitude of a day 1 lifetime loss is directly correlated with the principle that is still being developed to define this split.

5. Furthermore, the staff note that the boards have been discussing the principle for distinguishing the buckets based on the notion of collectability of the cash flows on the financial assets using the underlying concepts and definitions of rating classifications, coupled with concepts of regulatory guidance and other credit risk characteristics. Assets that are issued at a lower credit quality have a higher risk of uncollectability on initial recognition, so when assessing to which bucket an asset should be assigned to on the basis of credit quality, such assets would not be eligible for Bucket 1 on initial recognition.

6. As a result of the boards' request, the staff have identified the following alternatives:
   *To be applied **only** to entities whose 'primary' business model is to originate lower credit quality financial assets:*
   a. **Alternative A—exception for primarily high risk lenders:** require, or permit, the application of the Bucket 1 Approach[2]. The requirement, or option, could be applied to either the reporting entity or at a lower level.

   *To be applied to **all** entities irrespective of 'primary' business model:*
   b. **Alternative B—no exception for primarily high risk lenders:** require application of the Credit Quality Approach to all entities.
   c. **Alternative C—non-lifetime loss Bucket 2 measurement:** require a different measurement (eg 24 months, or a floor of 24 months) for all assets within Bucket 2 irrespective of whether they were originated at that level or deteriorated to it.
   d. **Alternative D—transfer based on credit risk level AND change in management objective:** require all entities to define the split between

[2] The Bucket 1 Approach is the same three-bucket impairment approach as the Credit Quality Approach except that all financial assets are classified in Bucket 1 upon initial recognition.

Buckets 1 and 2 by linking the credit risk level WITH the change in the credit risk management objective.

Alternative treatments

Alternative A—exception for primarily high risk lenders

7. **Overview of alternative:** using this alternative, if the primary business model is to originate assets at a lower credit quality, the entity/business unit[3] could either be
    a. ***required*** to apply the Bucket 1 Approach, if the split between Buckets 1 and 2 is defined at a *lower* credit quality (eg the lower end of the non-investment grade spectrum); or
    b. ***permitted*** to apply the Bucket 1 Approach if the split between Buckets 1 and 2 is defined at a *higher* credit quality level (eg the higher end of the non-investment grade spectrum).[4]
8. This alternative would be limited to entities/business units whose primary business model is to originate lower quality assets. It could be applied either at an entity level or a lower level depending on how the boards decide an entity should assess its 'primary business model'.

Issues to consider

Requirement or option to apply the Bucket 1 Approach

9. The boards were not keen on permitting entities to choose freely whether to apply a Bucket 1 Approach or a Credit Quality Approach (ie irrespective of the business model), because this could result in a lack of comparability between entities[5].

[3] For ease of discussing this alternative, the paper refers to 'business units'. However, as described in paragraph 14, if the boards were to pursue this alternative and wanted to assess the primary business model at a lower level than the reporting entity, they would need to consider the appropriate level for the assessment.

[4] As discussed in paragraphs 9-11, the staff believe that requiring or permitting this alternative depends on where the split between Buckets 1 and 2 is defined. The boards will address how to define the split in a later meeting.

[5] See September 2011 IASB Agenda Paper 4B/FASB Memorandum 110.

However, the staff have considered whether it may be appropriate to permit a more limited option only for those who are primarily high-risk lenders if the split between Buckets 1 and 2 is defined at a higher quality level.

10. **Option with a split at a higher credit quality**—if Bucket 1 is defined narrowly (eg the highest credit quality, so all non-investment grade assets are outside Bucket 1), then a large part of normal lending business would be assigned to Bucket 2 in the period of initial recognition. As a result, the 'primary business model' of several business units within most banks (and possibly even within entire reporting entities) would most likely be to originate assets outside Bucket 1. This would particularly be the case if the requirement were applied at a level below that of the reporting entity, because *requiring* the Bucket 1 Approach to apply to those business units would result in almost all entities having to track at least some of their assets to apply the Bucket 1 Approach of impairment accounting. This causes the same operational issues that led the boards to accept the Credit Quality Approach at the September 2011 meeting. Consequently, some of the staff believe that if the split between Buckets 1 and 2 is at the high credit quality level of the non-investment grade spectrum, then entities should be ***permitted*** to apply the Bucket 1 Approach if their business model is primarily to originate assets outside Bucket 1, but not be required to do so. This would allow those with the biggest day 1 lifetime loss issue to address it by making their own assessment of the costs versus benefits. However, because the split at the higher quality means that many entities/business units could be considered to have a primary business model to originate lower quality financial assets, some staff believe that this would effectively be similar to a free choice, which the boards did not support at the September 2011 meeting.
11. **Requirement with split at a lower credit quality**—if Bucket 1 is defined more broadly (eg the split between Buckets 1 and 2 is at a lower credit quality level of the non-investment grade spectrum), then there will be fewer normal lending activities that are classified outside Bucket 1 upon initial recognition. As a result, in these circumstances the results of the Bucket 1 Approach and the Credit Quality Approach would be similar for most entities. Consequently, some of the staff believe that if the principle underlying the split is at a lower quality level, then the entity/business unit

should be ***required*** to apply the Bucket 1 Approach as it would apply to a more limited number of entities.

12. **Broad application**—some staff believe that the boards did not intend that there should be a general exception for lower credit quality originations but rather that the boards were focusing on only those entities with less common business models. These staff do not think that it would appropriate to allow this alternative even on an optional basis if the test is applied below the reporting entity level (see next section), because the population of entities/business units applying the alternative could be greater than has been intended by the boards, which would cause non-comparability.

At which level to assess 'primary' business model

13. The boards initially directed the staff to consider whether it would be appropriate to provide an exception to the application of the Credit Quality Approach for entities whose primary business model was originating lower credit quality assets (ie high risk/high yield lending), for example, in some geographical areas. For this alternative, the boards should consider 'at what level' the assessment of the 'primary' business model should be performed.
14. The staff believe that the assessment could apply to (a) a (whole) reporting entity or (b) a lower level (ie to a portion of the reporting entity, eg geographical region, asset class, portfolio, operating segment, business unit, etc) depending on which population the boards wish to apply the Bucket 1 Approach. Considerations related to the level of assessment are:
    - **a. Reporting entity:** if the boards desire to only want to capture entities who primarily engage in originating lower quality assets overall, the assessment of the primary business model should be performed at the reporting entity level. This level of assessment would compare the level of origination of assets outside Bucket 1 to the origination of all assets for the reporting entity. The staff do not believe that the boards would need to specify whether an entity should perform the assessment by looking at specific components of the entire entity (portfolio, operating segment, business unit, etc) or by just looking at the overall business. A reason to

support assessing at the reporting entity level is that an entity would only be required or permitted (as relevant) to apply the Bucket 1 Approach if the Credit Quality Approach would create a significant day 1 lifetime loss.

b. **Lower level assessment:** if the boards want to capture specific components of an entity (eg business unit, operating segment, portfolio) that may primarily engage in originating lower quality assets, even if the whole entity does not have that primary business model, the assessment should be done at a lower level. This assessment would compare the origination of lower quality assets at the lower level to the total originations at the lower level. The Bucket 1 Approach would only be applied to that level of the entity (rather than the whole reporting entity). An example would be a retail bank that primarily lends to low risk obligors but also has a micro-lending business unit, or portfolio. The boards would need to consider at what level the assessment should be performed (eg business unit, operating segment, portfolio). If the boards wanted to make the Bucket 1 Approach mandatory for that lower level, then the definition of the lower level becomes critical to make the scope of the requirement clear. The definition is important for ensuring that all entities are applying a similar approach. Definitions for portfolio, business unit, etc do not exist in current literature, so would need to be developed. An assessment at this level would ensure that entities with significant high risk lending activity, but that do not 'primarily' have high risk lending activity overall, would be required, or permitted, to apply the Bucket 1 Approach.

15. As a result of those considerations, the staff have identified the following advantages and challenges of the alternative.

Advantages

16. **Operationally simpler for entities/business units that do not primarily engage in higher risk lending activities**—this alternative would only require tracking capabilities for those with a primary business model that results in them originating financial assets into a category below Bucket 1. Unlike the Bucket 1 Approach, this

alternative would not penalise entities/business units that do not engage primarily in high risk lending activities by requiring them to build systems capable of detailed tracking of deterioration of credit quality. Those entities/business units may still have some assets that are originated outside Bucket 1, and would have to recognise a day 1 lifetime loss on those assets. But because it would not be their primary business model, the entity/business unit should recognise, or be expected to recognise, only an immaterial amount of loss in the period of initial recognition (especially if the assessment is performed at a lower level).

17. **Information usefulness**—some staff believe that being able to distinguish between assets that were originated at lower credit qualities versus those that deteriorated to that quality provides useful information to users of financial statements.

Challenges

18. **Assessment at the reporting entity level—non-comparability**—entities with the same volume of originating lower credit quality assets may apply different models, because the volume may be significant to one entity, but not another. In addition, users may wish to compare a universal bank's 'micro-lending' business unit to a general micro-lender. However, the universal bank's micro-lending business unit may not cause the reporting entity to be 'primarily' engaged in high risk lending. Consequently, a user would not be able to compare the universal bank's micro-lending unit to a general micro-lender.
19. **Assessment at lower level—different models within entities**—different entities may have different business models for different business units. As a result, if the assessment of the primary business is done at a lower level than the reporting entity, for example the business unit, some business units may apply a Bucket 1 Approach, whereas others may apply a Credit Quality Approach. Although the outcomes of the two models in the financial statements may present comparable amounts, they may not be identical. This is because the business units that apply the Credit Quality Approach may still have some assets originated outside Bucket 1 (recognising a day 1 lifetime loss). This alternative thus introduces greater complexity for users. In addition, the entity has to apply two different models and thus needs multiple systems.

20. **Defining 'primary'**—what constitutes a 'primary' business model would need to be defined, irrespective of whether the assessment is at the reporting entity or at a lower level. The boards would need to decide whether:
    a. entities should make their own determination of what their 'primary' business is;
    b. whether 'primary' should be defined as a percentage of volume of assets compared to the total volume at the entity/business unit level, a percentage of the interest revenue expected on lower quality assets compared to total interest revenue for the entity/business unit, some other measurement to define 'primarily'; or,
    c. whether qualitative characteristics may be used for this assessment.
21. **Consistent application between periods**—even without using a bright line, the 'primary' business model may change between periods. For example, an entity/business unit that engages moderately, but not primarily, in lending to higher risk credits in one period may engage 'primarily' in lending higher risk assets in the next period or in periods when there is a downturn in the economy. As a result, entities/business units may flip back and forth between the models. This would result in significant, if not insurmountable, operational challenges and would be confusing for users of the financial statements. Alternatively, if the treatment was irrevocable (ie once in the primary business of making these loans, always in the primary business of making these loans), they could arguably continue to apply the Bucket 1 Approach even if they 'ceased' to primarily engage in high risk lending activities—that would result in a lack of comparability with similar entities.

Alternative B—no exception for primarily high risk lenders

Description

22. This alternative would require the application of the Credit Quality Approach to *all entities*.
23. The staff note that the boards specifically directed the staff to explore how minimise the day 1 lifetime loss effect for particular entities (ie those that primarily engage in

originating financial assets outside Bucket 1). However, given the analysis below, some staff believe there should be no exception for particular entities (ie all entities should apply the Credit Quality Approach.

Advantages

24. **Comparability**—because all entities are applying the same model, some staff believe that this alternative will ensure more consistency in application and comparability for users. Compared to an alternative that permits or requires an exception, these staff believe that not having an exception provides more transparency in the financial statements (including the underlying disclosures), because the buckets will include assets based on similar criteria.
25. **Operationally more simple**—although all staff acknowledge the conceptual merits of having all financial assets start in Bucket 1, the feedback received by many constituents has been that an approach that requires all assets to start in Bucket 1 (ie the Bucket 1 Approach) is operationally challenging and may not be cost-beneficial. During outreach, many entities acknowledged that they manage credit risk based on ratings/status at a point in time and not by tracking deterioration through time. Therefore, the staff who support providing no exception believe that the impairment model for all assets should be aligned with how credit risk is managed and with the credit risk at a point in time, including on origination. They believe that attempting to define which entities can forgo immediate recognition in Bucket 2, and when they can do so, may be as operationally complex as tracking the deterioration of financial assets.

Challenges

26. **Does not address day 1 lifetime loss for entities that primarily engage in high risk lending activities**—some board members have expressed concern about the magnitude of the impact of recognising a day 1 lifetime loss for entities that primarily engage in high risk lending activities. This alternative would not address that concern.

Alternative C—non-lifetime loss Bucket 2 measurement

Description

27. This alternative would be applied to *all entities* (irrespective of whether they primarily engage in high risk lending activities). The bucket classification determines the allowance amount to be recognised; for example, as follows:
    a. Bucket 1—12 months of expected losses[6];
    b. Bucket 2—non-lifetime loss, but greater than Bucket 1 allowance[7]; and
    c. Bucket 3—remaining lifetime expected losses.
28. The staff note that the boards appeared to dismiss this alternative at the September 2011 meeting[8] because it was not conceptual and provided bright lines. Furthermore, some board members believed that it would be more complicated, because it would add an additional measure. Other board members believed that it would be inappropriate to recognise less than full lifetime expected losses when an asset has heightened credit risk. However, some staff believe that this alternative should be reconsidered as a possible solution to address some board members' concerns with a day 1 lifetime loss recognition for assets originated outside Bucket 1, because:
    a. A single approach could be applied to all entities, so there would be no need to define what is meant by 'primary business model' (see paragraph 20).
    b. It alleviates the tracking issue because only the Credit Quality Approach would be applied (see paragraph 29).
    c. It is consistent with the tentative decision to accept the Credit Quality Approach for operational reasons, because all assets would be classified according to credit quality.

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[6] Twelve months is used as the bright-line in this example because the boards have previously decided that the allowance in Bucket 1 would be at either 12 or 24 months, to be decided later. However, the staff note that Bucket 1 does not have to be 12 months, and the boards could decide on something different in the future.

[7] One possibility for changing the measurement of the allowance balance in Bucket 2 is to make it a specific amount. Another is to make it a minimum amount (ie a floor of 24 months). If the boards would like to go down this path, the staff need to perform additional outreach to determine what the Bucket 2 measurement would be.

[8] See the September 2011 IASB Agenda Paper 4B/FASB Memorandum 110.

Advantages

29. **Operationally simpler**—This approach deals, in a simple way, with some board members' concern with a day 1 lifetime loss being recognised.
30. **Lessened cliff effect**—by having the Bucket 2 allowance balance equate to less than lifetime losses, but greater than the Bucket 1 allowance, the cliff effect is lessened for assets with a life greater than 24 months. This is because the deterioration of the credit quality is reflected in gradual steps (from a 12-month loss, to a 24-month loss, to a lifetime loss). Some constituents have expressed concern over the cliff effect that would result from moving from Bucket 1 to Bucket 2. However, others believe that this effect is appropriate, because of the heightened credit risk.

Challenges

31. **Additional measurement**—an entity would have to create additional models to be able to calculate a 12-month loss for Bucket 1, a 24-month loss[9] for Bucket 2, and a remaining lifetime expected loss for Bucket 3. Because that is not done today, it introduces an additional challenge. However, many constituents believe that this alternative could be implemented without significant changes to current processes by using their current models as a starting point. This is because constituents in some jurisdictions already calculate a 24-month loss on some of their assets (particularly commercial/corporate portfolios).
32. **Too little, too late**—as mentioned above, some constituents already calculate a 24-month loss on some of their assets. The staff are concerned that, in these cases, this alternative would not recognise losses earlier than they are recognised today. However, it appears that for retail portfolios, losses would likely be recognised earlier, because a 24-month loss is not currently calculated for this asset class.
33. **Bright line**—if the boards decide to limit the amount of impairment in Bucket 2 to a specific period that was shorter than lifetime, the measurement is based on an arbitrary bright line[10]. However, the staff also note that the current discussion around

[9] Or an alternative measure as determined to be appropriate, such as a floor of 24 months.

[10] While some board members would prefer a conceptual basis for measuring the allowance balance, for operational simplicity, the use of a bright line in Bucket 1 appears to have become palatable. So, to remove

the measurement of Bucket 1 (ie either 12 or 24 months) is also based on an arbitrary bright line.

34. **Non-comparability**—although assets are grouped together according to credit qualities, if a range is permitted for the allowance balance measurement in Bucket 2 (eg a floor of 24 months), then there will be non-comparability for the allowance balance in Bucket 2. Some staff are very concerned about allowing this flexibility, both because of the lack of comparability and also because of the risk of earnings management.

Alternative D—transfer based on credit risk level AND change in management objective

35. This alternative could be applied by *all entities*. Under this alternative, the transfer criteria would be modified from that previously discussed. An entity would allocate a financial asset to Bucket 2 when it has reached the credit quality commensurate with Bucket 2 AND the entity significantly changes its management objectives with respect to the financial asset. For banks, this would mean, for example, changing the credit risk management from merely monitoring and analysing regular performance updates, to actively engaging in managing the credit risk exposure; for example, by negotiating with the debtor certain waivers of, and/or amendments to the current credit terms. This would result in a distinction being drawn between lower credit quality loans that essentially behave as expected and those that have deteriorated. This alternative could be viewed as an extension of the Bucket 1 Approach because it should allow newly originated loans to be initially recognised in Bucket 1. The Bucket 1 Approach was dismissed by the boards in the September 2011 meeting on operational grounds.

Advantages

36. **Acknowledges that pricing incorporates consideration for expected loss**—when assets are originated, the pricing includes consideration for expected loss.

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the day 1 lifetime loss in Bucket 2 in a simplified way, as opposed to an integrated effective interest rate, or a time-proportional approach, using an arbitrary bright line may be a possible solution, albeit not conceptual.

Consequently, if the credit quality is low, that risk is already considered in pricing upon origination. Some staff feel that recognising a lifetime loss on those fairly priced assets before deterioration is inappropriate.

37. **Useful information**—some staff believe that being able to distinguish between assets that were originated at lower credit qualities versus those that deteriorated to that quality provides useful information to users of financial statements. By seeing this information, a user could analyse whether or not the assets are performing as anticipated.

Challenges

38. **Non-comparability**—this alternative creates non-comparability between entities (and within entities) because different portfolios will have assets of different credit quality in each of the buckets (see next paragraph).

39. **Operationalising the principle for the split between Buckets 1 and 2**—one of the challenges is identifying an appropriate principle related to credit risk management (and, the resulting uncertainty in collectability of cash flows) that is sufficiently clear to result in a comparable grouping of credit qualities of assets in each of bucket. The joint supplementary document (the SD), *Financial Instruments: Impairment*, included a credit risk management principle to describe the split between the good and bad books. Although feedback on the SD said that most (financial) institutions had a good and a bad book, constituents were concerned that the description of the split between the good and bad book in the SD was unclear. Although they believed they could operationalise it by, for example, looking at a regulatory definition of a bad loan[11], respondents asked that the principle be clarified. Based on discussions to date, the Bucket 1/Bucket 2 split is expected to be at a higher level than the good/bad book split in the SD. This will probably make it even *more difficult* to define a clear principle because the change in management would be even more subtle. This would make it both hard to define and harder to operationalise than the principle in the SD.

[11] Bad loans relate to a lower level of deterioration/credit quality than the staff currently envisages for the split between Buckets 1 and 2. As a result, trying to operationalise the split between Buckets 1 and 2 by using regulatory definitions for a bad loan would not result in loans transferring to Bucket 2 in a timely manner.

For example, during our outreach, the staff have learned that the change from passive to active credit risk management is not tied to a particular fixed credit risk level (eg B-). We have received preliminary feedback that identifying the point at which management changes in this way would likely be difficult to do in practice.

Staff recommendation

40. As the paper shows, there is no perfect solution to this issue. All of the approaches have material disadvantages. As a result, staff views are mixed.
41. Some staff recommend **Alternative A—exception for primarily high risk lenders** such that it would be a ***requirement*** to apply the Bucket 1 Approach, if the split between Buckets 1 and 2 is defined at a lower credit quality, or would be ***permitted*** to apply if the split between Buckets 1 and 2 is defined at a higher credit quality level. These staff recognise the difficulty in defining what is meant by 'primary' business model and that non-comparability among entities may occur, but they believe that requiring the recognition of full day 1 lifetime losses for assets originated in Bucket 2 is not appropriate.
42. Other staff believe that whenever two models are required or permitted, complexity increases. Ensuring that the appropriate model is applied in the appropriate circumstances will inevitably lead to writing rules. These staff believe that if the boards are concerned about operational complexity, then applying a single model to all entities may be an appropriate solution.
43. As a result, some staff recommend the boards apply either **Alternative B—no exception for entities that primarily engage in high risk lending activities** (ie require the Credit Quality Approach to apply in all cases) or **Alternative C—non-lifetime measurement in Bucket 2**. The staff who support either of these alternatives recognise that neither of them is conceptually pure, but believe that as the boards prefer an operationally simpler model, they have moved away from conceptual purity. The staff who prefer Alternative C over Alternative B also believe that changing the measurement of the allowance in Bucket 2 would help to alleviate the concern about significant day 1 lifetime losses.

44. No staff recommend **Alternative D—transfer based on credit risk level AND change in management objective**, because of the operational complexity that this alternative would seem to entail.

Question for the boards
1. Do the boards believe that an exception (Alternative A) should be required for application of the Credit Quality Approach for entities with a primary business model of originating low credit quality loans? **2. If yes to Question 1, at what level would the boards like the assessment of 'primary business model' to occur: at thereporting entity level, or at a lower level? If at a lower level, do the boards have any initial indications of what level they would like the staff to consider and try to define?** **3. If the boards answer 'no' to Question 1, do they prefer providing no exception (Alternative B) or modification of the allowance balance in Bucket 2 (Alternative C)? If Alternative C (non-lifetime loss in Bucket 2), do the boards have any initial thoughts on what the measurement should be in Bucket 2 (eg 24 months, floor of 24 months, etc)?**