



Staff
Paper

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Project	Financial instruments: Impairment		
Topic	Credit Risk Management Approach: Originated/purchased assets at lower credit quality		

Introduction

1. The Cover Paper, IASB Agenda Paper 4 / FASB Memorandum 108 provides brief background on the topic addressed in this paper.
2. The purpose of the paper is to discuss how to treat originated and purchased assets (see paragraph 3) with lower credit quality (ie medium to high risk) on initial recognition in the credit risk management approach. It therefore:
 - (a) presents a summary of the operational feedback received during our outreach activity;
 - (b) outlines the considerations to start originated or purchased assets with Bucket 1 measurement; and
 - (c) presents suggestions to alleviate the operational concerns expressed by our constituents during our outreach activity.

The staff requests direction from the boards on how to treat originated and purchased loans with lower credit quality, that are within the scope of this paper, on initial recognition.

3. The boards tentatively decided at the March 2011 meeting that loans acquired at a discount due to credit losses that would be recognised in the 'bad book' would have the EIR calculated taking into account initial credit loss expectations and that no allowance should be established on initial recognition. This is different from the accounting proposed for all other loans. As a result, once a basic model is established for all other loans, the appropriate bucket allocation for

loans acquired at a discount due to credit losses should be discussed. Those assets will be addressed separately, and are excluded from the discussion included in this paper.

4. However, depending on where the line is drawn between Buckets 2 and 3 in an approach that buckets assets according to credit quality, it may be possible to originate or purchase medium to high risk assets into either Bucket 2 or 3. This paper does not discuss the dividing line, so it will refer to being able to originate or purchase assets into either Bucket 2 or 3.
5. This paper does NOT address the more general question of when to transfer financial assets between buckets or where to draw the line between Bucket 1 and Bucket 2 on 'seasoned' (ie not new) assets (see IASB Agenda Paper 4C / FASB Memorandum 111 for discussion of this issue).
6. Furthermore, IASB Agenda Paper 4A / FASB Memorandum 109 includes some feedback we have received on the measurement for the allowance balance in Bucket 1.

Background

7. Under the credit risk management approaches discussed at the July meeting, the Bucket 1 allowance balance would be measured as the losses expected to occur in the next 12 or 24 months (the actual term has yet to be decided upon by the boards). The allowance balances in Buckets 2 and 3 would be measured as the remaining lifetime expected losses as tentatively decided in the June 2011 meeting¹.
8. With respect to how to define the buckets and classify assets accordingly, the boards considered two variations of the credit risk management approach (Approach 2A, now referred to as the 2A-Credit Quality Approach, and Approach 2B, now referred to as the 2B-Bucket 1 Approach, of the July 2011 IASB Agenda Paper 7A / FASB Memorandum 100). The only difference between these variations is how to initially treat originated and purchased assets

¹ See June 2011 IASB Agenda Paper 8 / FASB Memorandum 99.

within the scope of this document (ie the portion of expected losses to be recognised on initial recognition).

9. The following paragraphs summarise those two variations. The Appendix provides excerpts from the July paper (with minor wording changes to reflect current terminology) which describes the approach in more detail and presents some of the considerations related to it.

2A–Credit Quality Approach

10. In the 2A-Credit Quality Approach, the three buckets would capture the different levels of credit risk with Bucket 1 having the lowest level and Bucket 3 having the highest level of credit risk. Thus, all assets of like credit quality would be classified and the allowance measured according to groupings of similar credit qualities in the same bucket both upon origination/purchase and subsequently. As the credit quality changes, assets would move between buckets.
11. Assets that are originated or purchased with medium/high credit risk would be classified in Bucket 2 or Bucket 3 (depending on their level of credit quality) on initial recognition and, based on previous decisions, would have an expected lifetime loss recognised in the period of initial recognition. This lifetime ‘day-1’ loss consequence of the 2A-Credit Quality Approach was one of the driving factors for some board members to favour the 2B-Bucket 1 Approach².

2B–Bucket 1 Approach

12. In contrast to the approach described above there is one difference in the 2B-Bucket 1 Approach. Under the 2B-Bucket 1 Approach, at initial recognition all originated/purchased assets would be classified in Bucket 1 with 12 or 24 months of expected credit losses recognised (ie a ‘day-1’ loss).
13. Assets could only transfer out of Bucket 1 into Buckets 2 or 3 via deterioration in credit quality, affecting the uncertainty in collectability of cash flows (the

² It is important to note that under the 2B-Bucket 1 Approach (see paragraph 38), there still would be a ‘day-1’ loss consequence. This is a result of the boards’ tentative decision for Bucket 1 to require the recognition of an allowance balance (even upon origination or purchase) equal to 12 or 24 months of expected losses (the actual time period has yet to be decided by the boards). Potentially, for asset classes with shorter average lives, this may approximate a full life loss.

principle of when to transfer financial assets between the buckets is discussed in IASB Agenda Paper 4C / FASB Memorandum 111). So in Bucket 1, there would be loans of various credit qualities.

Operational feedback – the ‘tracking issue’

14. To date, the staff has spoken to a limited number of institutions in Europe, Asia, Australia, Africa, and North America. It appears that in some jurisdictions, systems which have been set up for using the Advanced Internal Ratings Based (A-IRB) approach of Basel II requirements would have less operational difficulties than those described below. However, even those institutions expressed concern that, although ratings history might be maintained, gathering data for accounting purposes would be a manually intensive process. They also noted that entities that do not apply the Basel A-IRB approach would likely not maintain ratings history (the staff confirmed that through outreach activities).
15. Through initial outreach activities, an operational concern with the 2B-Bucket 1 Approach was identified because:
 - (a) current systems do not monitor deterioration to the degree that a credit deterioration model would require; and
 - (b) historical loss expectation data (including risk grades) is not available in all cases.
16. This issue is referred to as the ‘tracking issue’ in this document and is further explained below.
17. In the 2B-Bucket 1 Approach, all assets start in Bucket 1 (regardless of credit quality), and the allowance for Bucket 1 is measured as 12 or 24 months of expected losses. So, for accounting purposes, all new assets are grouped together. However, for credit risk management purposes, assets with like credit qualities are managed together – no distinction is made between ‘old’ and ‘new’ assets. This means that just for accounting purposes it would be necessary to be able to distinguish those loans.
18. By requiring that all assets begin in Bucket 1, it would be necessary to:

- (a) Differentiate between assets with like credit qualities (say, a rating of 5) that:
- (i) deteriorated to that credit quality (eg rating 5 from original rating of 2) and transferred to Bucket 2 with a remaining lifetime loss recognised; *versus*
 - (ii) assets that are originated or purchased at that initial level of credit risk (eg rating 5) and included in Bucket 1 with an allowance of 12 or 24 months of expected losses.

In other words, tracking would be required to be able to differentiate, for accounting purposes, when an asset originated/purchased at a lower credit quality (within the scope of this paper) requires a less than lifetime loss allowance *versus* when it requires a remaining lifetime loss allowance.

- (b) Identify when an asset originated/purchased at a lower credit quality *deteriorates* such that it needs to be moved into Bucket 2. To do this properly it is necessary to know the original loss expectations (particularly because credit quality may first improve and then subsequently deteriorate but still be at a level above its original credit quality). To be accurate it would also be necessary to determine if a loan that deteriorates subsequently improves in credit quality to or above its original level of credit quality. That improvement would in principle cause the asset to transfer back into Bucket 1 and return to a 12 or 24 month expected loss amount for the allowance balance. This tracking requires information not only about this period's credit quality but the *original* credit quality even if the transfer was simplistically based on 'any' deterioration irrespective of severity³.

19. Much of the feedback received indicated that currently credit risk management systems are not built to track deterioration for the purposes described above (ie they do not track the credit quality at origination/purchase and subsequently).

³ We discussed a simplification during outreach whereby loans would be tracked only to their first deterioration and then treated like any other loan (so once a life time loss was recognised, even if the credit quality improved to a Bucket 2 level that was at or better than on origination, a lifetime loss would continue to be recognised) or tracked until their credit quality improved to that of a 'normal' Bucket 1 loan and then were treated like all other loans. The feedback we received was that the systems challenges would not be substantially improved.

Instead, credit risk management systems are built to manage assets (by asset class) of the same or similar credit qualities together. For example, all mortgage loans classified with a rating of 5 would be managed together, regardless of whether an asset is issued with a rating of 5 or deteriorated from 2 to 5.

20. In other words, the credit risk management systems are currently built to look at the credit quality of assets at the end of each reporting period. Historical and previous credit ratings or other indicators are not considered relevant except in a broader sense of looking more holistically at things such as credit migration patterns which would tend to be done at a less granular level and not necessarily to an auditable standard. Once the entity has identified the existence of indicators/loss events as defined in current literature, they can then determine the impairment amount, if applicable. So, instead of keeping detailed information on credit deterioration, they look at the credit quality at the end of the period and see if that level indicates that impairment should be recognised.
21. One of the biggest challenges identified during outreach was the question of how to create and link systems which track the required information and, at the same time, comply with audit requirements and regulatory requirements (including the Sarbanes-Oxley requirements for SEC filers). Furthermore, it would be difficult to go back in history to gather data on assets that are outstanding at the transition date of a new standard. Even if that data does exist (which is often *not* the case, according to feedback received so far), entities do not feel comfortable that the data they could gather would be accurate or able to withstand audit scrutiny absent significant systems changes.
22. Specifically, the feedback we received that related to data integrity and completeness listed the following challenges (which can be amplified when considering portfolios or businesses added to an existing operation through merger or acquisition):
 - (a) Incomplete data (central system receives and merges facility and issuer data from multiple sources, and matching can fail, thereby making information either unavailable or cumbersome to identify).

- (b) Problems with unique identifiers – the identification of an existing facility may be either retained or changed when the facility is renewed, extended or otherwise amended.
 - (c) When new systems have been implemented, in many cases only limited history is moved from prior systems.
 - (d) Due to re-organisations, portfolios can move to different business units and data systems, sometimes with a loss of history.
23. Consistent with previous messages received during various outreach activities, we heard that firms typically have multiple data systems for both rating and exposure data. Typically the customer rating information will be maintained in one or more credit systems whereas the exposure data is typically held in general ledger financial reporting systems. Hence, there is immediately a challenge in getting the different systems to integrate with each other.
24. One possible solution identified to help alleviate these tracking issues was to only require data to be maintained on a go-forward basis (ie from the date of transition, or from the purchase date of assets). The staff requested feedback on that suggestion, specifically the operationality of such an approach. Feedback suggested it would be slightly operationally simpler to have a starting date of transition/purchase, and only track on a prospective basis. However, they also stated (and wanted to make sure that this message was not lost) that ANY tracking would require the building of new systems, which depending on the quality of systems today and the population of an entity's portfolio, could be extremely costly. The feedback suggested that for most entities it would be extremely costly and it was stressed that the burden imposed should not be underestimated.
25. For example, they stated that inclusion of any additional data fields to legacy systems requires significant system lead time. Because many firms have multiple source systems containing product level information, often running into the hundreds to cover all products and all geographies, this would entail a major system overhaul.
26. The feedback suggested that such a change could take as long as two to three years, depending upon resource and budget availability (this is consistent with

the lead time estimate that was suggested for the IASB's original ED perhaps signifying that these changes could almost be as operationally difficult as the original ED). In some cases it would entail a systems re-design as older legacy systems may have capacity constraints that prohibit the inclusion of additional fields. One additional field will have a multiplier effect across 'n' million rows, and as these are embedded, the relationship to other fields and data is often complex.

27. We heard that while it is always preferable to start to build a new system from scratch, doing so runs the risk of disconnect to other risk and finance information – ratings will typically be in risk systems, maturity and drawn amounts in finance systems – and these need to be consolidated for financial reporting purposes.
28. The feedback did note that firms that have adopted Basel II will have made some progress in building systems to better integrate risk and finance systems, but the challenges still exist. One entity said that it took them over 3 years to update their systems for Basel II requirements on a majority of their portfolios.
29. The feedback reiterated previous concerns that *any* tracking of origination date ratings data, while possible, would have immediate issues that would have to be overcome including integration/linking of different data sources, validation/cleansing of existing data, expedients for missing data, etc.
30. In summary:
 - (a) While some limited tracking is undertaken today, for both compliance with accounting requirements and for internal research, that tracking is not at an individual exposure level, is often based on incomplete trend data and does not typically link back to origination date data.
 - (b) Such tracking as exists today is not performed at a standard that may meet audit or other regulatory requirements.
31. Although some banks may have limited tracking (as described in paragraph 30(a) above), it is likely that many smaller firms will not have any form of tracking or maintain origination ratings data – or if they do so, it is likely to be a manual-based system (such as in Excel spreadsheets). If a manual-based system, that means it will either be very costly to implement a new system or

more resources will be needed to manually track the additional data required and it raises the risk of error.

32. One suggestion to address this operational concern related to the tracking issue was that the buckets should be aligned with the credit quality of financial assets. This was the 2A-Credit Quality Approach in the July board paper that the boards did not favour. However, because of the feedback received to date, the staff feels it is important for the boards to consider whether such an approach (or variation on the approach) should be further considered (see discussion in paragraphs 40-58).
33. If the boards reconsider the previous tentative decision, as recommended by the staff, to follow the 2B-Bucket 1 Approach, the main resulting consequence is that some assets will be originated/purchased into Bucket 2 or 3, and, based on previous decisions regarding measurement of impairment losses, a 'day-1' lifetime loss will be recognised. However, the extent of that 'day-1' lifetime loss would depend on where the line between Bucket 1 and Bucket 2 is drawn. Clearly, the lower the line, the fewer assets will be originated/purchased into Buckets 2 or 3.

2B-Bucket 1 Approach⁴

Advantages

34. **Pricing acknowledgment (see the Appendix, paragraphs 6(b) and 7)** – In this model, there is acknowledgment that, conceptually, expected losses are incorporated into the pricing of assets (although that link is not perfect) – so, economically, a newly originated loan priced appropriately is not equivalent to a loan that has deteriorated in credit quality. However, this model is not based on the changes in pricing and it is likely that any subsequent link to the appropriateness of pricing will be at best very weak as movements between buckets are likely to be more closely tied to credit risk assessment. Also, there

⁴ See the Appendix for excerpts from the July paper (with minor wording changes to reflect current terminology) which describes the approach in more detail and presents some of the considerations related to it.

is still a loss recognised in the period of initial recognition – it is just likely smaller, depending on the average life of the portfolio (see paragraph 35).

35. **Less day-1 loss than under other approaches** – Because all assets start in Bucket 1, most assets would not have the total expected lifetime loss recognised in the period of origination (note: a shorter term asset may have the full lifetime loss recognised if its expected life is less than the 12 or 24 months eventually decided upon by the boards). So, compared to other approaches whereby assets with lower credit quality (however defined) have a remaining lifetime loss recognised in the period of initial recognition, this approach has ‘less’ day-1 loss. Some constituents preferred this approach for that reason because they do not believe it is conceptually appropriate to recognise lifetime losses in the initial period of recognition on assets priced appropriately. They recognised that there would still be some amount of day-1 loss in this approach in the Bucket 1 measurement, due to the recognition of 12 or 24 month expected losses but are more comfortable with that being minimised.
36. **Follows the credit deterioration principle (see the Appendix, paragraph 5)** – The guiding principle that has been used in developing a three-bucket approach has been to reflect the general pattern of credit deterioration in assets. Therefore, with all assets beginning in Bucket 1, the pattern of credit deterioration for *all assets* can be shown.

Challenges

37. **Tracking issue** – As described in paragraphs 14-33, the staff heard via outreach activities that an approach that starts all loans in the same bucket and therefore creates a disconnect between credit risk management and accounting, would be operationally difficult for current systems and costly to implement.
38. **Day-1 loss** – Although the day-1 loss amount in this approach is less than it would be in an approach that required the remaining lifetime loss to be recognised in the period of initial recognition for any originated/purchased assets, it does still exist because of the 12 or 24 month loss expectation recognised as the allowance amount for assets in Bucket 1. Furthermore, as described in paragraph 35, if the expected life of the asset is less than the 12 or

24 months, then the loss recognised on initial recognition in Bucket 1 will represent lifetime expected losses.

39. **Different impairment recognition for assets of identical credit quality** – This approach would result in assets of equal credit quality having different impairment amounts. Some stated that this outcome would be confusing for users of financial statements and would require significant explanation. In addition, while the approach follows the deterioration of an asset, it does not reflect the credit quality of assets and therefore does not align to credit risk management processes to the fullest extent.

2A-Credit Quality Approach⁵

Advantages

40. **Operationally simpler (see the Appendix, paragraph 4(b))** – This approach is operationally simpler than an approach that requires an entity to track assets with similar credit qualities separately for accounting purposes (as in the 2B-Bucket 1 Approach).
41. **Useful information** – Some have suggested that it would be easier for users to understand the model if all financial assets of like credit quality are in the same bucket with the same impairment accounting.

Challenges

42. **Day-1 loss (see the Appendix, paragraph 4(d))** – Similar to the 2B-Bucket 1 Approach, this approach has a day-1 loss. However, because originated/purchased assets with a lower credit quality would be initially classified into Bucket 2 or 3, a lifetime expected loss amount would be recognised in the period of initial recognition. As a result, the amount of loss recognised in the first period has the potential to be much greater for many originated or purchased assets than if the entity was applying the 2B-Bucket 1

⁵ See the Appendix for excerpts from the July paper (with minor wording changes to reflect current terminology) which describes the approach in more detail and presents some of the considerations related to it.

Approach. This lifetime day-1 loss will have the most significant impact for entities with a business model of purchasing/originating poorer quality assets. However, the significance of the amount recognised as a day-1 loss will be dependent on where the line between Bucket 1 and 2 is drawn. The overall impact will be less significant for entities in a 'steady state'.

43. **Does not acknowledge pricing (see the Appendix, paragraph 4(e))** – Because this approach recognises expected lifetime losses in the first period for originated/purchased assets at a lower credit quality (that are within the scope of this paper), it does not acknowledge that, conceptually, the pricing of an instrument includes the risk that a loss could occur on the originated or purchased asset or on assets of similar credit quality. Some believe that a true acknowledgement of that link would be allocating the losses over the life of the instrument. Note that even in the 2B-Bucket 1 Approach, the link to pricing is weak (as described in paragraph 34).

Variations to the 2A-Credit Quality Approach

44. The purpose of this section is to describe Variations to the 2A-Credit Quality Approach. The boards did not favour the 2A-Credit Quality Approach because of the recognition of expected lifetime losses in the initial period of recognition. But, on the basis of outreach performed to date mostly with preparers, it is favoured by many constituents because of the direct link to credit risk management (ie assets with like credit quality are grouped together) and because of the significant tracking issue many constituents have raised. Consideration could be given to seeking solutions to the day-1 loss problem to reduce, what some perceive to be, a major disadvantage of the 2A-Credit Quality Approach. As a result, this section discusses variations on that approach in order to eliminate, or reduce, the effect of recognising lifetime losses in the period of initial recognition for assets originated/purchased into any bucket other than Bucket 1.
45. The staff received feedback from some constituents who preferred the 2A-Credit Quality Approach that the measurement of Bucket 2, for all assets (even if not newly originated/purchased) should not be measured as full lifetime

losses. Instead, the suggestions for the measurement of that bucket ranged from 24 months up to lifetime, including allowing different asset classes to be measured using different time periods (depending on what credit risk management believes is the right time period for that particular asset class).

46. Some possible approaches to eliminate/reduce the lifetime loss day-1 effect in Bucket 2, with descriptions, advantages and challenges of each further below:
- (a) less than full remaining losses in bucket 2; or
 - (b) permit an option.

Less than full remaining losses in bucket 2

Description

47. For all assets classified as follows, regardless of whether deteriorated to that level or originated/purchased at that level, recognise an allowance amount, for example:
- (a) Bucket 1 – 12 months of expected losses⁶;
 - (b) Bucket 2 – at least 24 months of expected losses⁷; and
 - (c) Bucket 3 – remaining lifetime expected losses.

Advantages

48. **Reduced day-1 loss** – Because the assets in Bucket 2 only have, for example, at least 24 months of expected losses recognised, there is no full lifetime day-1 loss (depending on the life of the assets). The staff acknowledges that at least 24 months may result in different entities utilising different periods (some 24 months and some greater than 24 months) but some staff believe that this appropriately allows for greater judgment.

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 finally decided later. However, the staff notes that Bucket 1 does not have to be 12 months, and the boards could decide on something different in the future.

⁷ Note that this is just one possible approach for changing the measurement of the allowance balance in Bucket 2. The boards could choose any amount; 18 months, 24 months, 36 months, half of the remaining lifetime losses, etc. If the boards would like to go down this path, the staff needs to perform additional outreach to determine what the Bucket 2 measurement would be other than the lifetime losses.

49. **No tracking issue** – Because all assets within either Bucket 2 or 3 are measured consistently, and grouped according to credit quality, there is no tracking issue as described above.

Challenges

50. **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 (or greater) for Bucket 2, and a remaining lifetime expected loss for Bucket 3. Because that is not done today, it would be a challenge. However, many constituents believe that the operability of this approach could be implemented without significant concerns about changes to current processes (in fact, some asserted that it does not deviate significantly from current practices in some jurisdictions).
51. **Bright line** – If the boards decide to limit the amount of impairment in Bucket 2 to a shorter than lifetime period, the measurement is based on an arbitrary bright line. However, the staff also notes that the current discussion around the measurement of Bucket 1 (ie either 12 or 24 months) is based on an arbitrary bright line. In addition, the line between Bucket 2 and 3 would need to be defined as a point before incurred losses are recognised today, or the model may still end up with recognising ‘too little, too late’.
52. **Non-comparability** – Although assets are grouped together according to credit qualities, if a range is permitted for the allowance balance measurement in Bucket 2, then there will be non-comparability for the allowance balance in Bucket 2. Some assets will be measured using a 24 month loss, and some at greater than 24 months. Some staff are concerned about allowing this flexibility due both to the lack of comparability and also due to the risk of earnings management.

Permit an option

Description

53. Permit entities to choose between:

- (a) the operational complexity of setting up systems in order to track and measure originated/purchased loans in Bucket 2 or 3 for impairment accounting purposes (ie applying the 2B-Bucket 1 Approach); or
 - (b) take a lifetime loss immediately upon issuance/purchase into Bucket 2 or 3 (ie applying the 2A-Credit Quality Approach).
54. An entity could choose to set up systems to avoid having to recognise immediately a lifetime loss for assets originated/purchased into Bucket 2 or 3. This could be a free choice or be limited to entities with growing/new business lines or those with a business model to originate/purchase lower quality assets in particular asset classes (ie would not need to be the overall business model). For example, the option could be permitted only if the entity's business model is such that, depending on where the line between Bucket 1 and Bucket 2 is drawn, a material portion of its portfolio would be originated into Bucket 2, resulting in a large loss recognised in the period of initial recognition.
55. Once a choice is made, the boards may decide that the choice should be irrevocable (by asset class) to maintain consistency. Clear disclosures would also be required.

Advantages

56. **Reduced day-1 loss** – If an entity opts to build systems in order to track assets that are originated/purchased into Bucket 2 or 3, then they would be able to apply the boards' initially favoured approach (the 2B-Bucket 1 Approach). The allowance would be measured for those assets as if in Bucket 1 (ie 12 or 24 month loss estimate). This reduces the day-1 loss effect from a lifetime loss (depending on the life of the assets). Some constituents with whom we spoke stated that, depending on where the line was drawn between Buckets 1 and 2, they might prefer to invest in the systems development in order to apply a model that started all assets in Bucket 1, as opposed to taking a full lifetime day-1 loss on assets originated and purchased into Buckets 2 or 3.
57. **Operationally simpler** – This approach would not penalise entities that believe the cost/benefit implications of the 2B-Bucket 1 Approach justify using the 2A-Credit Quality Approach. If, for those cost/benefit considerations, an entity opts

to take a day-1 lifetime loss instead of building systems to track assets as discussed, it would measure the assets originated/purchased into Bucket 2 or 3 the same as the assets that have deteriorated to Bucket 2 or 3. Entities that might opt for this choice could be those that are in a steady state, or that do not typically invest in/issue lower quality assets.

Challenges

58. **Non-comparability** – Options increase non-comparability in financial reporting. Entities with the same business model could choose differently. This is unhelpful for users of financial statements.

Staff analysis

59. Since the genesis of the impairment project, staff has consistently heard messages related to the lack of historical credit data maintained by entities, the operational burden that would be imposed if significant systems changes were required, and that risk and finance systems are not integrated. While entities admit that such changes *could* be made, they express a strong view that such changes would be significant, costly and question the cost/benefit trade off. Many also questioned the relevance and usefulness to users of having assets with similar credit qualities reflecting different impairment amounts. They understood the conceptual basis for the 2B-Bucket 1 Approach. However, they believed that having like credit qualities recognised and measured in the same manner (ie the 2A-Credit Quality Approach) was more important from a cost/benefit perspective than the conceptual arguments for the 2B-Bucket 1 Approach.
60. After hearing similar feedback related to the operational difficulty of implementing the IASB's original exposure draft, the boards decided to try to identify an operational solution and have emphasised the benefits of trying to use existing credit risk management systems as a basis for the impairment model.
61. Given one of the overall objectives of the projects to replace the financial instruments standards is to reduce complexity, the staff is further concerned

about pursuing an approach that is (according to feedback received) more complex than the current accounting standards.

62. The staff reminds the boards that the preferred approach on which they voted in the July meeting was that all assets should be initially classified in Bucket 1 (ie the 2B-Bucket 1 Approach). However, the boards were made aware that such an approach might have some operational difficulty related to tracking credit deterioration, and would not always bucket assets in the same way that credit risk management currently manages such assets (ie in buckets with similar credit quality).
63. Based on the outreach performed, the staff believes that the tracking issue will pose significant operational concerns.
64. The staff notes that institutions with bigger budgets or with more sophisticated systems would be in a better position to build systems to be able to track the necessary data to apply the 2B-Bucket 1 Approach. The staff were also provided with feedback that building systems that would only require tracking of information from transition/purchase date forward would likely be costly to build, even for such larger institutions. However, the staff would be remiss to not clearly emphasise that many constituents speaking on behalf of smaller institutions were very concerned at how cumbersome such an approach would be for such institutions. The staff notes that given the operational complexity of the tracking issue, practical expedients and guidance would be necessary if the boards were to continue to develop an approach that would require any level of tracking.
65. Although the boards have generally been opposed to recognising full lifetime losses in the period of initial recognition, the staff notes that there is a trade-off between the complexity of the identified tracking issue and recognition of day-1 lifetime losses.
66. Therefore, the staff believes the boards should consider whether other approaches should be pursued.
67. The staff requests direction from the boards as to what approach they would like the staff to pursue. The staff believes there are at least these possible paths to pursue:

- (a) Continue to investigate whether an approach that starts all assets in Bucket 1 (ie the 2B-Bucket 1 Approach) can be operationalised. However, the staff would like to reiterate that they have performed much outreach over the life of the impairment project, and have consistently heard messages from the majority of constituents that there is a real operational issue with such an approach.
- (b) For operational reasons, accept an approach that buckets assets according to credit quality (ie the 2A-Credit Quality Approach) and recognises a lifetime loss in the period of initial recognition for assets originated/purchased into Bucket 2 or 3.
- (c) For operational reasons, accept an approach that buckets assets according to credit quality, but deals with the day-1 lifetime loss by one of the following:
- (i) Require a different measurement for *all* Bucket 2 assets, whether originated, purchased, or deteriorated into Bucket 2 (eg 24 months, a floor of 24 months, a range of 18-36 months, a different measurement, etc).
 - (ii) Allow an option (which could be restricted or unrestricted) for entities to either start all assets in Bucket 1 or apply the 2A-Credit Quality Approach.
 - (iii) Investigate other solutions.

Question to the boards for direction

Which direction would the boards like us to pursue and why:

- A. Continue to investigate operational issues to apply the 2B-Bucket 1 Approach;
- B. Accept full day-1 lifetime losses for assets originated/purchased into Bucket 2 or 3 and move to the 2A-Credit Quality Approach; or
- C. Try to address the day-1 lifetime loss for the 2A-Credit Quality Approach by creating a new measurement for Bucket 2, permitting an option for entities, or investigating other solutions?

APPENDIX

Approach 2: Credit risk management approaches

1. The staff have considered two alternative approaches that utilise aspects of credit risk management:
 - (a) 2A – Credit Quality Approach: An approach whereby the buckets would align with the credit quality of loans;
 - (b) 2B – Bucket 1 Approach: An approach whereby the buckets would be determined based on whether credit quality has deteriorated (or improved).

2A – Credit Quality Approach

2. Under this approach the objective is to reflect the change in credit quality of loans *consistent* with an entity's credit risk management practices. Credit quality is usually measured in terms of probability of default (PD), loss given default and exposure at default. Credit risk management systems differentiate between financial assets on the basis of their credit quality at the date of evaluation. By following credit risk management practices, the three buckets would capture the different levels of credit risk. Assets would be categorised by a specific level or range of credit risk, with Bucket 1 having the lowest level and Bucket 3 having the highest level of credit risk. As a loan is originated or purchased it would be classified in one of the three buckets in accordance with its level of credit risk, regardless of whether the pricing of the loan reflects the inherent credit risk upon origination or purchase. Depending on the magnitude of change in the level of credit risk, loans then migrate downward or upward into another bucket that is defined in line with the 'new' level of credit risk.
3. The staff envisions that this approach would be implemented by entities 'mapping' their existing credit rating categories to the three buckets. This could be done by establishing the credit risk characteristics of the loans that would fall within each of the three buckets in the impairment model. Entities would then

be required to map their internal risk rating categories to the three buckets based on the characteristics of their categories. Enough guidance would be needed so that entities that use credit risk rating systems with more or less than three categories could map their existing categories to these buckets on the basis of the primary characteristics of the categories. Also, even if an entity had only three categories, they may not necessarily align with how the guidance might differentiate the three buckets for impairment recognition purposes. It is also noted that some less sophisticated entities or entities in some industries (for example corporates) may not have such credit risk systems in place at all. However, the characteristics established for the buckets will still be used to guide the classification of loans within the three buckets for these entities.

4. The staff observes the following regarding this approach:
 - (a) Using entities' credit risk grading systems would align accounting and credit risk management.
 - (b) It does not raise the tracking issue that a model that puts all originated/purchased assets into Bucket 1 introduces so operationally it is expected to be less complex.
 - (c) Loans would be classified in accordance with their level of credit risk. In other words, loans of similar credit quality whether or not newly recognised would be classified together in buckets.
 - (d) If loans are originated or purchased with high credit risk (eg loans below investment grade or on a watchlist) these loans are allocated to high risk rating categories in credit risk management systems. Therefore, if credit risk rating systems were used as a basis for determining the impairment accounting buckets, some loans that are newly originated or purchased (such as micro loans or leveraged finance loans) would be classified into Bucket 2 due to their level of credit risk and lifetime expected credit losses would be recognised in the first reporting period.

- (e) Some staff believe that, conceptually, credit impairment losses should not be recognised immediately on a newly originated or purchased loan because, assuming those loans are priced at market, it would result in a better alignment of the credit risk embedded in the pricing of the instrument. Therefore, those staff believe that an event such as a deterioration in credit needs to occur before recognising the losses expected in original pricing.
- (f) As mentioned above, reporting entities may have credit risk systems with considerably more than three categories and they would need to map their existing categories to the three buckets on the basis of the primary characteristics of their categories. As a result, some are concerned there could be significant judgment as to how internal rating categories should be mapped to the impairment buckets for accounting purposes. This would result in a lack of comparability between entities. While the lack in comparability could be overcome by defining the three buckets using a scale from 0-100% for PDs (and staff is aware that PDs are very institution specific, that would create bright lines. This would mean that an arbitrary distinction between PDs would determine which buckets assets fall into, which has a profound effect on allowance balances. The staff learned during outreach activities that the rating scales and thus the level of PDs allocated to each category may vary by asset class.

2B-Bucket 1 Approach

- 5. The overall objective of this approach is to reflect the credit deterioration or improvement in loans making maximum use of credit risk management practices.
- 6. This approach:

- (a) Does not require particular types of events to be identified as a basis for transfer;
 - (b) Considers the concept that the expectation of credit losses priced into the loan would not be reflected in the financial statements until deterioration starts to occur, which some believe results in a better alignment of the credit risk embedded in the pricing of the instrument;
 - (c) Incorporates some credit risk management practices; and
 - (d) Instead of the level of credit risk, it is based on *changes* in credit risk.
7. This approach would result in the movement of loans between buckets depending on changes in credit loss expectations. Under this approach, all originated and purchased loans would initially start in Bucket 1 (because the loss expectations are embedded in the pricing, some consider it inappropriate to recognise remaining lifetime expected losses in the first period⁸). This means that loans of varying credit quality would be recognised in Bucket 1 (because loans of varying credit quality are originated and purchased). However the credit loss expectations used to determine the allowance balance for Bucket 1 would reflect the varying credit quality within that category. This means that when high risk loans are newly originated the expected losses used to determine the bucket 1 allowance balance would be higher.
8. Given loans with varying credit quality would be recognised in Bucket 1 and a transfer to Bucket 2 is based on a change in credit loss expectation, there may in fact be some loans with a higher credit risk in Bucket 1 than some other loans in Bucket 2. For example, consider a loan that is originated on market terms to a low quality obligor (high credit risk) and a loan that is originated on market terms to a high quality obligor (low credit risk). Upon origination both loans

⁸ It is noted that purchases of loans acquired at a discount due to credit losses are outside the scope of this paper due to the boards' earlier decision to adjust the effective interest rate for those loans to reflect the initial credit loss expectations. Because the effective interest rate is calculated differently than for all other financial assets subject to impairment accounting, those loans will be considered separately. As a result, it is assumed that all loans considered in this paper are performing at the time of origination or purchase when considered on an individual basis.

would be classified in Bucket 1. If the loan to the high quality obligor deteriorates in credit risk, the loan would be transferred from Bucket 1 to Bucket 2 even though it might still have an absolute level of credit quality that is higher than the loan that remained in Bucket 1.

9. The principle would focus on movements across rating categories (see IASB Agenda Paper 4C / FASB Memorandum 111 of the September 2011 meeting for discussion on the transfer between buckets).
10. A difficulty with using transfers between credit risk categories is the variation in categories used between entities. This means that focussing in isolation on whether there has been a transfer between categories for internal credit risk management purposes may not be an appropriate basis for determining whether there should be a transfer between buckets for impairment accounting purposes. It also raises issues with comparability. However, transfers of financial assets between buckets could be based upon several indicators, for example capitalising on the Basel capital framework and related risk management processes (eg reviewing some regulatory guidance as a starting point for developing indicators). This could involve for example changes in expectations regarding recoverability of cash flows and drawing on the borrowers' status as performing, non-performing or defaulted, and their deterioration within an internal credit risk grading system.