

# STAFF PAPER

**16 April-18 April 2012**

REG FASB | IASB Meeting

Project	Financial Instruments: Impairment		
Paper topic	Clarification of the measurement objectives		
CONTACT(S)	Steve Kane	<a href="mailto:smkane@fasb.org">smkane@fasb.org</a>	+1 (203) 956-3424
	Rosemarie Sangiuolo	<a href="mailto:rsangiuolo@fasb.org">rsangiuolo@fasb.org</a>	+1 (203) 956-5426
	Trent Handy	<a href="mailto:tthandy@fasb.org">tthandy@fasb.org</a>	+ 1 (203) 956-3466
	Natalie Watanabe	<a href="mailto:nlwatanabe@fasb.org">nlwatanabe@fasb.org</a>	+1 (203) 956-5296
	Manuel Kapsis	<a href="mailto:mkapsis@ifrs.org">mkapsis@ifrs.org</a>	+44 (0)20 7246 6411
	Jana Streckenbach	<a href="mailto:jstreckenbach@ifrs.org">jstreckenbach@ifrs.org</a>	+44 (0)20 7246 6473

This paper has been prepared by the staff of the IFRS Foundation and the FASB for discussion at a public meeting of the FASB or IASB. It does not purport to represent the views of any individual members of either board. Comments on the application of U.S. GAAP or IFRSs do not purport to set out acceptable or unacceptable application of U.S. GAAP or IFRSs. The FASB and the IASB report their decisions made at public meetings in FASB *Action Alert* or in IASB *Update*.

---

## Purpose of this paper

1. The purpose of the paper is to discuss two issues relating to previous tentative decisions by the boards regarding the measurement objective of expected credit losses and to provide recommendations for clarifying the boards' intention in making those decisions.
2. The first issue discusses how the boards should articulate the objective of expected credit losses. This paper seeks to address some constituents' expressed concerns about complexity resulting from a previous decision by the boards to require entities to estimate expected losses with the objective of expected value.
3. The second issue in this paper discusses the objective for the Bucket 1 impairment allowance. In recent months, the staff have received a number of questions from constituents regarding the Bucket 1 measurement objective. This paper seeks to clarify that objective.

**Issue 1—Measurement objective of expected credit losses**

4. The three-bucket credit impairment model that the boards are developing includes two impairment allowance measurement objectives based on expected credit losses. A “lifetime expected credit loss” measurement objective applies to financial assets in which the level of credit deterioration subsequent to initial recognition would represent that (1) there has been a “more than insignificant” deterioration in credit quality and (2) the likelihood that some or all of the contractual cash flows may not be collected is at least “reasonably possible” (ie, the assets in Bucket 2 or Bucket 3). For other financial assets (ie, those in Bucket 1) the model applies a credit loss measurement objective of “12 months of expected credit losses”.
5. The boards have previously reached the following tentative decisions as to *how* the expected losses amounts would be measured under the model:
- (a) The measurement of expected losses should reflect shortfalls in cash flows (both principal and interest) on a discounted basis.<sup>1</sup>
  - (b) An entity should use all reasonable and supportable information (historical, current, and forecast) to estimate expected losses.<sup>2</sup>
  - (c) Expected losses should be estimated with the objective of an expected value. An expected value identifies possible outcomes (or a representative sample of the possible outcomes), estimates the likelihood of each outcome, and calculates a probability-weighted average. The boards acknowledged that other appropriate methods could be used as a reasonable way to achieve the expected value objective. An example of a suitable method would be a loss rate method and the use of probabilities of default, loss given default and exposure at default data. In performing

---

<sup>1</sup> See IASB Agenda Reference 4B/FASB Reference 84 presented in April 2011, and related Summary of Decisions Reached (SDR).

<sup>2</sup> See IASB Agenda Reference 1B/FASB Reference 69 presented in November 2010, and related SDR. This tentative conclusion also served the foundation for later discussions surrounding the use of expected value for a measurement approach, as discussed in paragraph 32 of IASB Agenda Reference 4B/FASB Reference 80 presented in March 2011, and related SDR.

this calculation, an entity must not ignore observations and possibilities that are known.<sup>3</sup>

6. Some constituents have raised concerns that the use of the term ‘expected value’ would require entities to apply complex statistical approaches when calculating expected credit losses. However, it is the staff’s understanding that the boards’ intention was not to mandate complex statistical analysis. In fact, the boards do not believe that, in practice, the calculation must be unduly onerous, requiring a rigorous mathematical exercise in which every single possible outcome and its probability is required to be identified and used. The key point is that more than one outcome is considered and that consideration is given to the likelihood of alternative outcomes occurring.
7. The staff believe that the following two paragraphs summarise the boards’ tentative decisions to date while clarifying the objective of expected credit losses.
8. **An estimate of expected credit losses shall reflect the following:**
  - (a) **All reasonable and supportable information considered relevant in making the forward-looking estimate.**
  - (b) **A range of possible outcomes that considers the likelihood and reasonableness of those outcomes (that is, it is not merely an estimate of the ‘most likely outcome’).**
  - (c) **The time value of money.**
9. **In estimating expected credit losses, a reporting entity shall consider information that is reasonably available without undue cost and effort.**

#### Question to the boards

1 - Do the boards agree with how the staff has described the measurement objective for expected credit losses in paragraphs 8-9?

<sup>3</sup> See IASB Agenda Reference 4B / FASB Reference 80 presented in March 2011, and related SDR.

## Issue 2—Bucket 1 measurement objective

### *Background and previous tentative decisions reached*

10. At the July 2011 joint board meeting, the boards discussed the measurement of expected credit loss on financial assets in Bucket 1. At that meeting, the boards agreed to keep the calculation of the impairment allowance for Bucket 1 operationally simple. The boards directed the staff to explore approaches that would calculate the allowance using 12 or 24 months' worth of losses expected to occur. The boards also agreed that the calculation of 12 months' worth of expected losses in Bucket 1 would be based on an annual rather than an annualised loss rate (ie, looking to the losses that are expected to occur in the next 12 months, as opposed to calculating the lifetime losses and dividing by the number of years remaining). The same logic would apply to a calculation based on 24 months.<sup>4</sup>
11. At the December 2011 joint board meeting, the boards continued their discussion on the Bucket 1 credit impairment allowance. At that meeting, the boards tentatively decided that the objective and measurement in Bucket 1 would be to capture 12 months' expected losses. The losses being measured are not only the cash shortfalls over the next twelve months, but also the lifetime expected losses on the portion of financial assets on which a loss event is expected over the next twelve months.<sup>5</sup>
12. Since December 2011, the staff have received a number of questions from constituents regarding the objective for the Bucket 1 impairment allowance and on how an entity may calculate the Bucket 1 allowance.

---

<sup>4</sup> See IASB Agenda Reference 7B/FASB Reference 101 presented in July 2011, and related SDR.

<sup>5</sup> See IASB Agenda Reference 6A/FASB Reference 118 presented in December 2011, and related SDR.

### *Summary of concerns raised and approaches*

13. As discussed in December 2011, the intention of Bucket 1 is *not* simply to capture the actual cash shortfalls that are expected in the next 12 months. In December the measurement objective was described as:

“the lifetime expected losses on the portion of financial assets on which a loss event is expected over the next twelve months”.

14. However, it is apparent that many constituents have understood the Bucket 1 measurement objective as mandating a single measurement approach. In addition, some staff are concerned that describing the Bucket 1 measurement objective as indicated above could be taken to imply that an entity is required to use an approach that includes “the probability of a loss event” as an explicit input (eg, a ‘probability of default’ or ‘PD’ approach). Some of the staff are concerned that such an approach, if required, would be unduly restrictive, and would not accurately reflect the boards’ intentions.
15. In essence, the staff believe this issue is primarily one of how best to describe the measurement outcome for “12 months’ expected losses” and does not ultimately change the desired outcome of the boards, which is that the 12-month measurement of expected losses should be used for Bucket 1 in such a way that the 12-month measurement refers to more than simply the actual cash shortfalls that are expected in the next 12 months. Furthermore, the staff believe that various methods could be consistent with the intended Bucket 1 measurement approach, including a 12-month PD approach or an annual loss rate approach. The staff have identified the following approaches for articulating the Bucket 1 measurement objective:
- (a) **Approach A—Expected losses for the portion of financial assets on which a loss event is expected over the next 12 months.** This approach explains the concept of “12 months’ expected credit losses” as first identifying the portion of the portfolio upon which a “loss event” is expected in the next 12 months and then measuring expected credit losses that will be ultimately realised as a result of those loss events occurring. An entity may

define ‘loss event’ in a variety of ways, including transferring from Bucket 1, payment default, reaching a certain number of days past due status, or default as defined by regulatory frameworks such as Basel (ie, 90 days past due).

- (b) **Approach B—12 months’ expected credit losses.** This approach describes the credit impairment allowance measurement objective for Bucket 1 financial assets as being ‘12 months’ expected credit losses’ and would provide application guidance illustrating examples of acceptable techniques for measuring ‘12 months’ expected credit losses’, such as a 12-month PD approach or an annual loss rate approach.
- (c) **Approach C—Expected losses for those financial assets on which a loss event is expected in the next 12 months.** This approach would describe the objective of ‘12 months’ expected credit losses’ as measuring all cash shortfalls expected over the full lifetime that are associated with the probability of a loss event in the next twelve months. Approach C would include an acknowledgement that various approaches can be used to estimate the Bucket 1 allowance, as long as the result is consistent with the objective as discussed in Issue 1 (including approaches that do not include an *explicit* 12-month probability of a loss event as an input).

### *Staff analysis*

16. **Approach A**—Approach A describes the Bucket 1 measure as a two-step process, with Step 1 being to identify a portion of the portfolio upon which a “loss event” is expected in the next 12 months and Step 2 being to measure the expected losses related to the financial assets identified in Step 1. Approach A would not explicitly include the word ‘lifetime’ in the description of the losses that would be measured. Instead, this approach would require that at each reporting period an entity would be required to “estimate cash flows not expected to be collected based on all reasonable and supportable information”.

17. Regardless of how an entity defines the “loss event,” the staff expect that the calculated Bucket 1 allowance typically would be similar. This similarity results from the fact that for a static set of historical data, decomposing “actual losses” into (1) a probability of an event happening and (2) the “loss given the event happening” causes a counteracting effect between the two ‘components’ in this approach. Said differently, if a broader definition of “loss event” is used, the “loss realised as a result of the loss event” (ie, the severity) is smaller.
18. Under Approach A, a 12-month PD approach is typically thought of as a two-step process and would be consistent with the notion described in this approach. Similarly, while an annual loss rate approach is typically thought of as a one-step process, it would be consistent with the notion described in this approach. Specifically, an annual loss rate approach would inherently use ‘charge-off’ as the loss event for purposes of Step 1. In that way, the loss rate is a single-step process that essentially combines a ‘probability of charge-off’ and the ‘loss given charge-off’.
19. The staff who support Approach A think that describing “12 months’ expected credit losses” as a two step process makes it clear that the losses being measured are not only the cash shortfalls over the next 12 months. In addition, the staff who support Approach A do not think this approach is contingent on explicitly including or excluding specific guidance on various approaches that may be used to determine the Bucket 1 allowance.
20. **Approach B**—Unlike Approach A, this approach describes the Bucket 1 measure as a one-step process (ie, 12 months’ expected losses), and would then provide application guidance illustrating examples of acceptable techniques for measuring “12 months of expected credit losses,” such as how either a 12-month PD approach (which some staff think of as a two-step process) or an annual loss rate approach (which some staff think of as a one-step process) may be consistent with the required attributes of “12 months’ expected credit losses.”
21. Some staff think that Approach B alleviates the concerns regarding the tentative decision to date by describing the measurement of the Bucket 1 impairment

allowance at a higher level that contains no implication as to ‘how many steps’ the measurement approach is required to include, or whether an entity is required to use an approach that includes “the probability of a loss event” as an *explicit* input.

22. **Approach C**—Other staff think that the concerns regarding the tentative decision to date could be alleviated by acknowledging (in the description of the Bucket 1 measurement or in application guidance) that various approaches may be used to determine the Bucket 1 allowance (including approaches that do not include an *explicit* 12-month probability of a loss event as an input, such as a loss rate methodology).
23. The staff who support Approach C do not think that the boards should articulate the measurement objective in more general terms such as Approach B. Such an approach may result in entities misinterpreting the measurement objective to be a measure of expected cash shortfalls over the next 12 months, or of annualised lifetime expected losses. Likewise, an approach that does not make specific reference to lifetime shortfalls in cash flow, such as Approach A, may result in entities misinterpreting the measurement objective to be a measure of cash shortfalls over a period shorter than lifetime. The staff who support Approach C understand that this may not actually be the intention of Approaches A and B, but they would prefer the objective to include an explicit reference to lifetime for clarity.
24. Approach A would allow loss events to be defined in a variety of ways, including transferring from Bucket 1, whereas Approach C would maintain the tentative decision that a loss event does not include transferring from Bucket 1.
25. Approach C refers to “the probability [or likelihood] of a loss event occurring in 12 months” instead of simply a reference to “a loss event expected over the next twelve months”. The staff who support Approach C favour this explanation to prevent misinterpretation that only expected losses on assets where there is a 100 per cent probability of a loss event occurring in 12 months should be included. Such a misinterpretation could result in a Bucket 1 measurement that is similar to today’s incurred losses under IFRS.



26. Approach B would require, and Approach A would be open to provide, application guidance illustrating examples of acceptable techniques for measuring “12 months’ expected credit losses”. The staff who support Approach C do not think that the proposals should include any details of approaches or of methods of determining the impairment allowance. These staff are concerned that listing acceptable methods would risk ruling out other appropriate methods for measuring the Bucket 1 allowance, or be interpreted as providing unconditional acceptance of a particular method even when such a measure results in an amount that is not consistent with the required attributes of an expected loss measure.

### Staff recommendation

27. The staff are not unanimous in their recommendation, with some staff favouring each of the approaches described, for the reasons noted above.

#### Question to the boards

2. How do the boards prefer that the ‘Bucket 1’ credit impairment allowance measurement objective should be described?